COPY

# TRANSCRIPT OF RECORD

## Supreme Court of the United States

OCTOBER TERM, 1960

## No. 151

JOHN T. JARECKI, FORMER COLLECTOR OF INTERNAL REVENUE, ET AL., PETITIONERS,

*vs.*

G. D. SEARLE & CO.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

PETITION FOR CERTIORARI FILED JUNE 16, 1960
CERTIORARI GRANTED OCTOBER 10, 1960

# Supreme Court of the United States

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*vs.*

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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[fol. 1]

# IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

## APPENDIX FOR PLAINTIFF-APPELLANT

## IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION

No. 57-C-1717

G. D. SEARLE & Co., a corporation, PLAINTIFF,

*vs.*

JOHN T. JARECKI, former Collector of Internal Revenue, and ERNEST J. SAUBER, former Collector of Internal Revenue and former District Director in Internal Revenue, DEFENDANTS

### PREFIX TO RECORD

This action was brought by G. D. Searle & Co. on complaint filed October 16, 1957, in the United States District Court for the Northern District of Illinois, Eastern Division. Defendants John T. Jarecki and Ernest J. Sauber answered on December 16, 1957. Defendants filed two sets of interrogatories on May 29 and June 11, 1958, which were answered by plaintiff on June 13 and July 11, respectively. A stipulation of facts was filed on February 16, 1959. On plaintiff's motion, the court ordered separate trial of certain issues on February 19, 1959. Requests for admissions under Rule 36 were filed by both parties; defendants' on March 19 and plaintiff's on March 23, 1959. Answers to these requests were filed on March 30 by plaintiff, and by defendants on April 2 after their objec-
[fol. 2] tions were overruled following oral argument on March 31. On March 31 defendants also presented a motion for summary judgment. Briefs were filed by both parties and argument heard on April 28. On May 11,

Judge Igoe entered findings of fact, conclusions of law and summary judgment for defendants. Plaintiff filed notice of appeal on July 10, 1959.

Pleas had at a regular term of the United States District Court for the Eastern Division of the Northern District of Illinois begun and held in the United States Court Rooms in the City of Chicago in the Division and District aforesaid on the first Monday of May, being the 4th day thereof, in the Year of Our Lord One Thousand Nine Hundred Fifty-Nine and of the Independence of the United States of America, the 183rd Year.

Present:

Honorable Gunnar H. Nordbye, District Judge.
Honorable William J. Campbell, Chief District Judge.
Honorable Philip L. Sullivan, District Judge.
Honorable Michael L. Igoe, District Judge.
Honorable Walter J. La Buy, District Judge.
Honorable J. Sam Perry, District Judge.
Honorable Julius J. Hoffman, District Judge.
Honorable Julius H. Miner, District Judge.
Honorable Edwin A. Robson, District Judge.
Roy H. Johnson, Clerk.
William W. Kipp, Sr., Marshal.

Monday, May 11, 1959.

Court Met Pursuant to Adjournment.

Present: Honorable Michael L. Igoe, Trial Judge.

[fol. 3] IN THE
UNITED STATES DISTRICT COURT

* * * *

COMPLAINT—Filed October 16, 1957

Plaintiff, G. D. Searle & Co., a Delaware corporation, for its complaint alleges as follows:

COUNT I.

1. This action is brought pursuant to the provisions of the Act of June 25, 1948, c. 646, 62 Stat. 932, U. S. C. Title 28, § 1340, to recover an internal revenue tax, to wit, excess profits tax, erroneously and illegally assessed. Plaintiff is a corporation duly organized and existing under the laws of the State of Delaware and has its principal office at Searle Parkway, Skokie, Illinois.

2. During all times material to this proceeding plaintiff was engaged in, and derived its income from, the sale of ethical drugs manufactured by plaintiff.

3. As a result of plaintiff's activities extending over a period of more than twelve months, to wit, the calendar years 1946 to 1949, inclusive, plaintiff discovered two compositions of matter, the ethical drugs respectively called Banthine and Dramamine, and new and valuable clinical applications therefor.

4. The only products which plaintiff discovered, and from which discoveries plaintiff derived income during any time material to this proceeding, are Banthine and Dramamine.

5. During the calendar year 1950 plaintiff derived income of a class described in Section 456 of the Internal Revenue Code of 1939 from its discovery of Banthine and Dramamine. Such income constituted a class of income [fol. 4] which is reasonable in a business of the type which plaintiff conducts and is appropriate in the light of plaintiff's business experience and accounting practice.

6. On or before March 15, 1951 plaintiff filed its tentative corporate income and excess profits tax returns for the calendar year 1950, and on or before June 13, 1951

plaintiff filed its final corporate income tax return for the calendar year 1950, with defendant John T. Jarecki, then Collector of Internal Revenue for the First Collection District of Illinois, in which plaintiff erroneously reported excess profits tax liability in the total amount of $558,339.11. Plaintiff erroneously paid this amount to John T. Jarecki, then Collector as aforesaid, in installments as follows:

| Date | Amount |
|---|---|
| March 15, 1951 | $169,020.42 |
| June 13, 1951 | 165,983.05 |
| September 14, 1951 | 111,667.82 |
| December 14, 1951 | 111,667.82 |

Thereafter, on or about December 12, 1952, plaintiff erroneously paid to defendant Ernest J. Sauber, then District Director of Internal Revenue at Chicago, Illinois, additional excess profits tax erroneously and illegally assessed for the calendar year 1950 in the amount of $1,537.32.

7. During the calendar year 1950 plaintiff realized and included in its gross income for such year net abnormal income attributable to previous years, to wit, the calendar years 1940 to 1949, inclusive, resulting from discovery of Banthine and Dramamine, and erroneously included in its income tax return for 1950 the net abnormal income attributable to such previous years and erroneously paid the tax shown due by reason of such erroneous inclusion. [fol. 5] 8. Plaintiff's net abnormal income for the calendar year 1950 and the excess profits tax which plaintiff erroneously paid with respect thereto are determined and computed as follows:

(a) Plaintiff's net abnormal income.

(i) Plaintiff's abnormal income consisting of gross profit (net sales less cost of sales) from sales of Banthine and Dramamine ..... $4,977,986

| | | |
|---|---|---|
| Plaintiff's gross profits from sales of such drugs for preceding four calendar years: | | |
| 1946 | $ 0 | |
| 1947 | 0 | |
| 1948 | 0 | |
| 1949 | 809,458 | |
| Total | $ 809,458 | |
| Plaintiff's average gross profit for such years | $ 202,364 | |
| (ii) Reduction of 115% of such average gross profit | | $ 232,719 |
| | | $4,745,267 |

[fol. 6] (iii) Reduction for expenses attributable to abnormal income, determined as follows:

| | | |
|---|---|---|
| Amount of costs and deductions for the calendar year 1950 relating to plaintiff's net abnormal income for calendar year 1950 allowable in determining plaintiff's normal tax net income for calendar year 1950 | $1,638,010 | |
| Ratio (percentage) which plaintiff's abnormal income for calendar year 1950, reduced as provided in subparagraph (ii) above ($4,745,267), bears to plaintiff's net abnormal income for calendar year 1950 ($4,977,986) | 95.33% | |
| 95.33% of such costs and deductions for calendar year 1950 | | 1,561,515 |
| (iv) Plaintiff's net abnormal income for calendar year 1950 | | 3,183,752 |
| Amount of plaintiff's net abnormal income allocated to: | | |
| Item Banthine | $1,964,768 | |
| Item Dramamine | 1,218,894 | |
| Total | $3,183,752 | |

(b) Excess profits tax erroneously paid by plaintiff.

| | |
|---|---|
| Plaintiff's adjusted excess profits tax net income for calendar year 1950 | $3,702,081.00 |
| Less exclusion of net abnormal income | 3,183,752.00 |
| Adjusted excess profits net income without inclusion of net abnormal income | 518,329.00 |
| Excess profits tax at 30% | 155,498.70 |
| Total excess profits tax paid by plaintiff for calendar year 1950 | 559,876.43 |
| 184/365ths of $155,498.70 | 78,388.39 |
| Excess profits tax erroneously paid by plaintiff for calendar year 1950 | $ 481,488.04 |

[fol. 7] 9. On or about March 10, 1954 plaintiff duly filed with defendant Ernest J. Sauber, District Director of Internal Revenue as aforesaid, claim for refund of excess profits tax for the calendar year 1950 based upon the inclusion in plaintiff's excess profits net income for the calendar year 1950 of net abnormal income derived from Banthine and Dramamine as aforesaid. The grounds for allowance of such claim for refund were set out in the claim in substantially the form herein set forth.

10. On October 27, 1955 the Secretary of the Treasury mailed to plaintiff, by registered mail, a notice of the disallowance of plaintiff's claim for refund of excess profits tax for the calendar year 1950.

11. Plaintiff erroneously made payments in respect of its excess profits tax liability for the calendar year 1950 in the amount of $481,488.04. Plaintiff is entitled to a refund under the provisions of Section 6511 of the Internal Revenue Code of 1954 in the sum of $481,488.04 or such greater amount as this Court may determine, together with interest thereon at the rate of 6% per annum from the respective dates of payment, as aforesaid, until paid to plaintiff.

Wherefore plaintiff prays judgment against defendants in the sum of $481,488.04, or such other greater amount as this Court may determine, together with interest thereon at the rate of 6% per annum from the respective dates

of payment, as aforesaid, until paid to plaintiff, and for any other, further and different relief to which this Court may find plaintiff entitled.

In the alternative plaintiff prays judgment against defendant Ernest J. Sauber in the amount of $1,537.32, together with interest thereon at the rate of 6% per annum from December 12, 1952 until paid to plaintiff; and against defendant John T. Parecki in the amount of [fol. 8] $481,488.04, or such other greater amount as this Court may determine, together with interest thereon at the rate of 6% per annum from the respective dates of payment as aforesaid until paid to plaintiff; and for any other further and different relief to which this Court may find plaintiff entitled.

COUNT II.

1-4, inclusive. Plaintiff hereby adopts, by reference, paragraphs 1 to 4, inclusive, of Count I hereof as paragraphs 1 to 4, inclusive, of Count II.

5. During the calendar year 1951 plaintiff derived income of a class described in Section 456 of the Internal Revenue Code of 1939 from its discovery of Banthine and Dramamine. Such income constituted a class of income which is reasonable in a business of the type which plaintiff conducts and is appropriate in the light of plaintiff's business experience and accounting practice.

6. On or before March 13, 1952 plaintiff filed with defendant John T. Jarecki, then Collector of Internal Revenue for the First Collection District of Illinois, its corporate income and excess profits tax returns for the calendar year 1951 in which it erroneously reported excess profits tax liability in the total amount of $2,047,010.81. Plaintiff erroneously paid this amount to John T. Jarecki, then Collector as aforesaid, in installments as follows:

| Date | Amount |
|---|---|
| March 13, 1952 | $716,453.79 |
| June 13, 1952 | 716,453.78 |
| September 12, 1952 | 307,051.62 |
| December 12, 1952 | 307,051.62 |

7. During the calendar year 1951 plaintiff realized and included in its gross income for such year net [fol. 9] abnormal income attributable to previous years, to wit, the calendar years 1946 to 1949, inclusive, resulting from discovery of Banthine and Dramamine, and erroneously included in its income tax return for 1951 the net abnormal income attributable to such previous years and erroneously paid the tax shown due by reason of such erroneous inclusion.

8. Plaintiff's net abnormal income for the calendar year 1951 and the excess profits tax which plaintiff erroneously paid with respect thereto are determined and computed as follows:

(a) Plaintiff's net abnormal income.

| | | |
|---|---|---|
| (i) Plaintiff's abnormal income consisting of gross profit (net sales less cost of sales) from sales of Banthine and Dramamine | | $10,760,993 |
| Plaintiff's gross profits from sales of such drugs for preceding four calendar years: | | |
| 1947 | $ 0 | |
| 1948 | 0 | |
| 1948 | 809,458 | |
| 1950 | 4,977,986 | |
| Total | $5,787,444 | |
| Plaintiff's average gross profit for such years | $1,446,861 | |
| (ii) Reduction of 115% of such average gross profits | | $1,663,890 |
| | | $9,106,103 |

[fol. 10] (iii) Reduction for expenses attributable to abnormal income, determined as follows:

| | | |
|---|---|---|
| Amount of costs and deductions for the calendar year 1951 relating to plaintiff's net abnormal income for calendar 1951 allowable in determining plaintiff's normal tax net income for calendar year 1951 | $2,642,807 | |
| Ratio (percentage) which plaintiff's abnormal income for calendar year 1951, reduced as provided in subparagraph (ii) above ($9,106,103), bears to plaintiff's net abnormal income for calendar year 1951 ($10,769,993) | 84.55% | |
| 84.55% of such costs and deductions for calendar year 1951 | | $2,234,493 |
| (iv) Plaintiff's net abnormal income for calendar year 1951 | | 6,871,610 |
| Amount of plaintiff's net abnormal income allocated to: | | |
| Item Banthine | $5,602,275 | |
| Item Dramamine | 1,269,335 | |
| Total | $6,871,610 | |

[fol. 11] (b) Excess profits tax erroneously paid by plaintiff.

| | |
|---|---|
| Plaintiff's adjusted excess profits tax net income for calendar year 1951 | $7,015,456 |
| Less exclusion of net abnormal income | 6,871,610 |
| Adjusted excess profits net income without exclusion of net abnormal income | 143,846 |
| Excess profits tax at 30% | 43,153.80 |
| Total excess profits tax paid by plaintiff for calendar year 1951 | 2,047,010.81 |
| Correct excess profits tax | 43,153.80 |
| Excess profits tax erroneously paid by plaintiff for calendar year 1951 | $2,003,857.01 |

9. On or about March 10, 1955 plaintiff duly filed with defendant Ernest J. Sauber, District Director of Internal Revenue as aforesaid, claim for refund of excess profits tax for the calendar year 1951 based upon the inclusion in plaintiff's excess profits net income for the calendar year 1951 of net abnormal income derived from Banthine and Dramamine as aforesaid. The grounds for allowance of such claim for refund were set out in the claim in substantially the form herein set forth.

10. On October 27, 1955 the Secretary of the Treasury mailed to plaintiff, by registered mail, a notice of the disallowance of plaintiff's claim for refund of excess profits tax for the calendar year 1951.

11. Plaintiff erroneously made payments in respect of its excess profits tax liability for the calendar year 1951 in the amount of $2,003,857.01. Plaintiff is entitled to a [fol. 12] refund under the provisions of Section 6511 of the Internal Revenue Code of 1954 in the sum of $2,003,857.01 or such greater amount as this Court may determine, together with interest thereon at the rate of 6% per annum from the respective dates of payment, as aforesaid, until paid to plaintiff.

Whereof plaintiff prays judgment against defendants in the sum of $2,003,857.01, or such other greater amount

as this Court may determine, together with interest thereon at the rate of 6% per annum from the respective dates of payment, as aforesaid, until paid to plaintiff, and for any other, further and different relief to which this Court may find plaintiff entitled.

In the alternative plaintiff prays judgment against defendant John T. Jarecki in the amount of $716,453.79, together with interest thereon at the rate of 6% per annum from March 15, 1952 until paid to plaintiff; and against defendant Ernest J. Sauber in the amount of $2,003,857.01, or such other greater amount as this Court may determine, together with interest thereon at the rate of 6% per annum from the respective dates of payment as aforesaid until paid to plaintiff; and for any other further and different relief to which this Court may find plaintiff entitled.

## Count III.

1-4 inclusive. Plaintiff hereby adopts, by reference, paragraphs 1 to 4 inclusive, of Count I hereof as paragraphs 1 to 4, inclusive, of Count III.

5. During the calendar year 1952 plaintiff derived income of a class described in Section 456 of the Internal Revenue Code of 1939 from its discovery of Banthine and Dramamine. Such income constituted a class of income which is reasonable in a business of the type which plain-
[fol. 13] tiff conducts and is appropriate in the light of plaintiff's business experience and accounting practice.

6. On or before March 13, 1953 plaintiff filed with defendant Ernest J. Sauber, then District Director of Internal Revenue at Chicago, Illinois, its corporate income and excess profits tax returns for the calendar year 1952 in which it erroneously reported excess profits tax liability in the total amount of $1,634,421.14. Plaintiff erroneously paid this amount to Ernest J. Sauber, then District Director as aforesaid, in installments as follows:

| Date | Amount |
|---|---|
| March 13, 1953 | $653,768.46 |
| June 15, 1953 | 653,768.46 |
| September 15, 1953 | 163,442.11 |
| December 15, 1953 | 163,442.11 |

Thereafter, on or about September 29, 1955, plaintiff erroneously paid to defendant Ernest J. Sauber, then District Director as aforesaid, additional excess profits tax erroneously and illegally assessed for the calendar year 1952 in the amount of $12,492.63.

7. During the calendar year 1952 plaintiff realized and included in its gross income for such year net abnormal income attributable to previous years, to wit, the calendar years 1946 to 1949, inclusive, resulting from discovery of Banthine and Dramamine, and erroneously included in its income tax return for 1952 the net abnormal income attributable to such previous years and erroneously paid the tax shown due by reason of such erroneous inclusion.

8. Plaintiff's net abnormal income for the calendar year 1952 and the excess profits tax which plaintiff erroneously paid with respect thereto are determined and computed as follows:

[fol. 14] (a) Plaintiff's net abnormal income.

| | | |
|---|---|---|
| (i) Plaintiff's abnormal income consisting of gross profit (net sales less cost of sales) from sales of Banthine and Dramamine | | $9,796,150 |
| Plaintiff's gross profits from sales of such drugs for preceding four calendar years: | | |
| 1948 | $ 0 | |
| 1949 | 809,458 | |
| 1950 | 4,977,986 | |
| 1951 | 10,769,993 | |
| Total | $16,557,437 | |
| Plaintiff's average gross profit for such years | $ 4,139,359 | |
| (ii) Reduction of 115% of such average gross profit | | $4,760,263 |
| | | $5,035,887 |

[fol. 15] (iii) Reduction for expenses attributable to abnormal income, determined as follows:

| | | |
|---|---|---|
| Amount of costs and deductions for the calendar year 1952 relating to plaintiff's net abnormal income for calendar year 1952 allowable in determining plaintiff's normal tax net income for calendar year 1952 | $ 2,900,505 | |
| Ratio (percentage) which plaintiff's abnormal income for calendar year 1952, reduced as provided in subparagraph (ii) above ($5,035,887), bears to plaintiff's net abnormal income for calendar year 1952 ($9,796,150) | 51.41% | |
| 51.41% of such costs and deductions for calendar year 1952 | | 1,491,150 |
| (iv) Plaintiff's net abnormal income for calendar year 1952 | | 3,544,737 |
| Amount of plaintiff's net abnormal income allocated to: | | |
| Item Banthine | $ 2,579,658 | |
| Item Dramamine | 965,079 | |
| Total | $ 3,544,737 | |

[fol. 16] (b) Excess profits tax erroneously paid by plaintiff.

| | |
|---|---|
| Plaintiff's adjusted excess profits tax net income for calendar year 1952 | $5,191,472 |
| Less exclusion of net abnormal income | 3,544,737 |
| Adjusted excess profits net income without inclusion of net abnormal income | 1,646,735 |
| Excess profits tax at 30% | 494,020 |
| Total excess profits tax paid by plaintiff for calendar year 1952 | 1,646,913.77 |
| Correct excess profits tax | 494,020 |
| Excess profits tax erroneously paid by plaintiff for calendar year 1952 | $1,152,893.77 |

9. On or about March 5, 1956 plaintiff duly filed with defendant Ernest J. Sauber, District Director of Internal Revenue as aforesaid, claims for refund of excess profits tax for the calendar year 1952 based upon the inclusion in plaintiff's excess profits net income for the calendar year 1952 of net abnormal income derived from Banthine and Dramamine as aforesaid. The grounds for allowance of such claim for refund were set out in the claim in substantially the form herein set forth.

10. On February 14, 1957 the Secretary of the Treasury mailed to plaintiff, by registered mail, a notice of the disallowance of plaintiff's claim for refund of excess profits tax for the calendar year 1952.

11. Plaintiff erroneously made payments in respect of its excess profits tax liability for the calendar year 1952 in the amount of $1,152,893.77. Plaintiff is entitled to a refund under the provisions of Section 6511 of the Internal Revenue Code of 1954 in the sum of $1,152,893.77 or such greater amount as this Court may determine, together with interest thereon at the rate of 6% per

[fol. 17] annum from the respective dates of payment, as aforesaid, until paid to plaintiff.

Wherefore plaintiff prays judgment against defendant Ernest J. Sauber in the sum of $1,152,893.77, or such other greater amount as this Court may determine, together with interest thereon at the rate of 6% per annum from the respective dates of payment, as aforesaid, until paid to plaintiff, and for any other, further and different relief to which this Court may find plaintiff entitled.

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*Attorneys for Plaintiff.*

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Chicago 3, Illinois,
*Of Counsel.*

[fol. 18] IN THE
UNITED STATES DISTRICT COURT

* * * *

ANSWER—Filed December 16, 1957

Come now the defendants and answer the plaintiff's complaint as follows:

COUNT I.

1. Admits the allegations of paragraph 1, except defendants deny that any taxes were erroneously or illegally assessed or collected from the plaintiff.

2. Defendants admit that plaintiff manufactures and sells ethical drugs, but are without knowledge or information sufficient to form a belief as to whether plaintiff derives all its income from the manufacture and sale of ethical drugs.

3. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations of paragraph 3.

4. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations of paragraph 4.

5. Deny the allegations of paragraph 5.

6. Deny the allegations of paragraph 6, except defendants admit that plaintiff filed its corporate income and excess profits tax returns for the calendar year 1950 on or about the dates alleged and reported excess profits tax liability in the amount stated. Defendants deny that plaintiff paid any amount of taxes erroneously and allege that income and excess profits taxes for the taxable year [fol. 19] 1950 were paid by the plaintiff to the defendants in the following amounts and on the following dates:

| | |
|---|---|
| March 15, 1951 | $1,200,000.00 |
| June 20, 1951 | 1,178,439.14 |
| October 2, 1951 | 792,813.04 |
| December 16, 1951 | 10,479.22 |
| January 5, 1952 | 792,813.04 |

7. Deny the allegations of paragraph 7.

8. Deny the allegations of paragraph 8.

9. Defendants admit that plaintiff filed a claim for refund on or about March 10, 1954, but deny each and every allegation in said claim or in support thereof not specifically admitted elsewhere herein.

10. Admit the allegations of paragraph 10.

11. Deny the allegations of paragraph 11.

COUNT II.

1-4, inclusive. Defendants adopt by reference paragraphs 1 to 4, inclusive, of their answers of Count I hereof as paragraphs 1 to 4, inclusive of Count II.

5. Deny the allegations of paragraph 5.

6. Deny the allegations of paragraph 6, except defendants admit that plaintiff filed its corporate income and excess profits tax returns for the calendar year 1951 on March 14, 1952 and reported excess profits tax liability in the amount of $2,047,010.81, and that plaintiff paid to the defendant the following amounts on the following dates:

| | |
|---|---|
| March 14, 1952 | $2,822,350.29 |
| August 18, 1952 | 2,822,350.29 |
| December 16, 1952 | 1,209,578.69 |
| December 19, 1952 | 1,209,578.68 |

7. Deny the allegations of paragraph 7.

8. Deny the allegations of paragraph 8.

9. Defendants admit that plaintiff filed a claim for refund, but deny each and every allegation in said claim [fol. 20] or in support thereof not specifically admitted elsewhere herein.

10. Admit the allegations of paragraph 10.

11. Deny the allegations of paragraph 11.

COUNT III.

1-4, inclusive. Defendants adopt by reference paragraphs 1 to 4, inclusive, of their answers of Count I hereof as paragraphs 1 to 4, inclusive, of Count III.

5. Deny the allegations of paragraph 5.

6. Deny the allegations of paragraph 6, except defendants admit that plaintiff filed its corporate income and

excess profits tax returns for the calendar year 1952 on March 16, 1953 and paid the following amounts on the following dates:

| | |
|---|---|
| March 16, 1953 | $2,806,485.54 |
| June 29, 1953 | 2,806,485.54 |
| September 25, 1953 | 701,621.39 |
| December 17, 1953 | 701,621.38 |
| October 4, 1955 | 38,614.23 |

7. Deny the allegations of paragraph 7.
8. Deny the allegations of paragraph 8.
9. Admit that plaintiff filed a claim for refund, but deny each and every allegation in said claim or in support thereof not specifically admitted elsewhere herein.
10. Admit the allegations of paragraph 10.
11. Deny the allegations of paragraph 11.

Wherefore, having fully answered, the defendants pray for dismissal of the plaintiff's complaint, for judgment in their favor, for the costs of this action, and for all other relief which to the Court may seem just and proper.

R. Tieken,
*United States Attorney.*

[fol. 21] IN THE
UNITED STATES DISTRICT COURT

• • • • •

DEFENDANT'S INTERROGATORIES TO PLAINTIFF—Filed May 29, 1958

Pursuant to Rule 33, Federal Rules of Civil Procedure, defendants request plaintiff to answer the following interrogatories separately and fully in writing and under oath, and to serve a copy upon undersigned counsel for defendants within fifteen days after service hereof:

1. Name the patented drugs for which plaintiff has applied for and been granted a patent on the chemical formula by the United States Patent Office.

2. List the dates that the patents described in Interrogatory 1, above, were issued by the United States Patent Office.

3. State the income received from the sale of plaintiff's own patented drugs described in Interrogatory 1, above, from 1940 through 1953, inclusive.

R. Tieken,
*United States Attorney.*

Proof of service
(omitted in printing)

[fol. 22] IN THE
UNITED STATES DISTRICT COURT

• • • •

DEFENDANT'S INTERROGATORIES TO PLAINTIFF—Filed June 11, 1958

Pursuant to Rule 33, Federal Rules of Civil Procedure, defendants request plaintiff to answer the following interrogatories separately and fully in writing and under oath, and to serve a copy upon undersigned counsel for defendants within fifteen days after service hereof:

1. State the research facilities devoted by plaintiff to the research and development of ethical drugs from 1940-1953, inclusive.

2. State the research staff devoted by plaintiff to the research and development of ethical drugs from 1940-1953, inclusive.

3. State the research expenses devoted by plaintiff to the research and development of ethical drugs from 1940-1953, inclusive.

R. Tieken,
*United States Attorney.*

Proof of service
(omitted in printing)

[fol. 23] IN THE
UNITED STATES DISTRICT COURT

* * * *

PLAINTIFF'S ANSWER TO DEFENDANTS' INTERROGATORIES

On May 29, 1958, the defendants served three interrogatories upon the plaintiff. Plaintiff answers those interrogatories as follows:

1. From 1940 through 1953, plaintiff applied for and was granted patents on the chemical formulas of the following drugs* that it marketed:

Pavatrine Dramamine Banthine

2. The dates that the foregoing patents were issued by the United States Patent Office are as follows:

| | |
|---|---|
| Pavatrine | November 18, 1941 |
| Dramamine | February 28, 1950 |
| Banthine | November 17, 1953 |

3. During said period, plaintiff received the following income (gross sales) from those drugs:

| | 1940 | 1941 | 1942 | 1943 | 1944 | 1945 | 1946 |
|---|---|---|---|---|---|---|---|
| Pavatrine | | | $512 | $ 167,326 | $ 378,936 | $ 618,320 | $ 770,826 |
| Dramamine | | | | | | | |
| Banthine | | | | | | | |

| | 1947 | 1948 | 1949 | 1950 | 1951 | 1952 | 1953 |
|---|---|---|---|---|---|---|---|
| Pavatrine | $894,562 | $945,314 | $1,064,072 | $1,005,178 | $ 844,939 | $ 776,174 | $ 682,911 |
| Dramamine | | | $ 908,398 | $2,044,797 | $2,484,406 | $3,324,933 | $3,629,280 |
| Banthine | | | | $3,328,606 | $9,347,180 | $8,348,212 | $8,506,288* |

* Includes Pro-Banthine.

K. D. Bowes, *Treasurer, G. D. Searle & Co.*

Subscribed and sworn to before me this 12th day of June, 1958.
(Seal) Dorothy M. Purck, *Notary Public.*

* We have not included in the classification of drugs an antiseptic that plaintiff sold in negligible quantities from 1941 to 1945.

[fol. 24] IN THE
UNITED STATES DISTRICT COURT

* * * *

PLAINTIFF'S ANSWERS TO DEFENDANTS' INTERROGATORIES OF JUNE 11, 1958

Plaintiff considers the Government's second set of interrogatories, served on June 11, 1958, to be irrelevant to the issues herein and therefore objectionable. However, to save the time of the Court and to avoid delaying the disposition of this cause, but without waiving any objections as to relevancy, plaintiff answers those interrogations as follows:

1. From 1940 until March 1942, Searle's research facilities consisted of laboratories in the Company's quarters at Ravenswood and Lawrence Avenues in Chicago, Illinois. In March 1942, Searle occupied its Building A in Skokie, Illinois, consisting of 107,400 square feet, of which 12,400 square feet were occupied by Searle's research facilities. In 1947, an additional 11,600 square feet were added in research facilities, and 2,700 square feet were simultaneously released in Building A. Thus in 1947, Searle's research facilities occupied 21,300 square feet. In 1948, 17,100 square feet were added, and in 1950 an additional 12,400 square feet were added, making a total of 50,800 square feet, in contrast to Searle's non-research facilities space of 204,100 square feet.[1]

[fol. 25] 2. The following chart depicts Searle's research staff from 1943 through 1953 (the figures are unavailable for 1940 through 1942):

[1] The figures in paragraph 1 are of course approximations.

G. D. SEARLE & CO.

Research Personnel

| Research | 1943 | 1944 | 1945 | 1946 | 1947 | 1948 | 1949 | 1950 | 1951 | 1952 | 1953 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Analytical & Control [2] | | | | | 17 | 21 | 23 | 27 | 27 | 29 | 25 |
| Biology Labs. | | | | | 18 | 21 | 24 | 37 | 40 | 50 | 56 |
| Chemical Research | | | | | 16 | 19 | 23 | 24 | 37 | 48 | 50 |
| Clinical | | | | | 2 | 2 | 2 | 3 | 4 | 4 | 5 |
| Research office, Library, Patents | | | | | 6 | 6 | 5 | 6 | 8 | 9 | 7 |
| Biology office | | | | | | | | | 5 | 3 | 3 |
| Chemical Research Office | | | | | | | | | | | 3 |
| Dishwashing, Stockroom | | | | | | 1 | 1 | 1 | 4 | 5 | 5 |
| Animal Room | | | | | 4 | 4 | 6 | 6 | 7 | 9 | 9 |
| Research Engineering [3] | | | | | | 3 | 3 | 3 | 3 | 3 | 3 |
| | 23 | 26 | 32 | 47 | 63 | 77 | 87 | 107 | 135 | 160 | 166 |

3. Searle's research expenses for 1949 through 1953 are as follows (the figures are unavailable for 1940 through 1948):

| | |
|---|---|
| 1949 | $887,660 |
| 1950 | $1,166,486 |
| 1951 | $1,613,272 |
| 1952 | $2,130,190 |
| 1953 | $1,861,266 |

K. D. Bowes,
*Treasurer, G. D. Searle & Co.*

Subscribed and sworn to before me this 7th day of July, 1958.

Gertrude C. Biesmann,
*Notary Public.*

(Seal)

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[2] Although persons in this group report to Searle's Vice President In Charge of Research, actually their work is largely non-research work.

[3] See note 2 above.

[fol. 26] IN THE
UNITED STATES DISTRICT COURT

* * * *

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties hereto that for the purpose of this action the following facts are to be taken as true, subject to the right of either party to introduce such further evidence as is not inconsistent herewith:

1. Plaintiff is a Delaware corporation with its principal place of business in Skokie, Illinois. It brings this action to recover excess profits taxes which it alleges were erroneously and illegally assessed and collected by defendants for the calendar years 1950, 1951 and 1952.

2. Plaintiff manufactures and markets ethical drugs and derives income therefrom.

3. Prior to 1950, and over a period of more than twelve months, plaintiff incurred expenditures which resulted in the preparation and manufacture of two pharmaceuticals whose trade names are, respectively, Banthine and Dramamine.

4. During the years 1950, 1951 and 1952, plaintiff derived income from the sales of Banthine and Dramamine. It is this income which the plaintiff claims constituted abnormal income within the meaning of Section 456(a)(2) of the Internal Revenue Code of 1939. This claim, which is controverted by the defendants, is the sole basis of the complaint in this case.

[fol. 27] 5. Plaintiff applied for and received product patents on the following drugs that it marketed during the 1940-1953 period:

| Product | Filed | Granted |
|---|---|---|
| Pavatrine | 4-20-40 | 11-18-41 |
| Dramamine | 3-18-49 | 2-28-50 |
| Banthine | 5-10-52 | 11-17-53 |

its applications for such patents were denied on the following:

| Product | Filed | Abandoned |
|---|---|---|
| Hydryllin | 4-29-47 | 7-10-52 |
| Tetrathione | 8-7-42 | 4-30-48 |

Walter J. Cummings, Jr.,
*Attorney for Plaintiff,*

R. Tieken,
*Attorney for Defendants.*

IN THE UNITED STATES DISTRICT COURT

* * * * *

ORDER RE TRIAL ISSUES—Febuary 19, 1959

The Court, having considered the plaintiff's motion for separate trials of the issues herein pursuant to Rule 42(b) of the Federal Rules of Civil Procedure, and having heard arguments of counsel and being fully advised in the premises, hereby orders that the questions whether or not plaintiff's income from Banthine and Dramamine was income resulting from "discovery" constituting a class of income under the provisions of subparagraph (B) of Sec- [fol. 28] tion 458(a)(2) of the Internal Revenue Code of 1939 or was income of a class not described in subparagraphs (A) and (D), inclusive, of such section and subject to Regulations prescribed by the Secretary of the Treasury shall be tried in advance of the remaining issues herein, which shall be held in abeyance pending final decision of those questions, including any appellate review thereof.

The Government having no objection, it is further ordered that a trial by jury herein is waived.

Enter:
Igoe,
*United States District Court Judge.*

IN THE UNITED STATES DISTRICT COURT

• • • •

REQUEST FOR ADMISSIONS UNDER RULE 36—Filed March 19, 1959

The defendants, John T. Jarecki and Ernest J. Sauber, request the plaintiff, G. D. Searle & Co., a corporation, within ten (10) days after service of this request to make the following admissions for the purpose of this action only and subject to all pertinent objections to admissibility which may be made.

1. That Exhibit A, attached to this request, is an accurate photostat of a statement submitted by the plaintiff to the Internal Revenue Service during 1943.

2. That Exhibit B, attached to this request, is an accurate photostat of a prospectus issued by the plaintiff on February 7, 1950, covering the matters and issued for the purposes stated therein.

3. That Exhibit C, attached to this request is an accurate photostat of a statement submitted by the plaintiff to the Internal Revenue Service during 1943.

[fol. 29] 4. That Exhibit D, attached to this request, is an accurate photostat of the plaintiff's annual report for the year 1950, which report was distributed to its shareholders.

5. That Exhibit E, attached to this request, is an accurate photostat of the plaintiff's annual report for the year 1951, which report was distributed to its shareholders.

6. That each of the following statements is true:

(a) In a meeting dated January 16, 1950, the Board of Directors of the plaintiff voted to insert the following wording in Article Four of its Articles of Incorporation, which article deals with the purposes of the plaintiff's business.

> To engage in, carry on, or otherwise conduct, or employ others to conduct, general research or investigation for the development of new or improved products or by-products or uses for such

products or by-products, for improving the case or efficiency of the corporation or for other purposes.

(b) That, according to the laws of the state of plaintiff's incorporation, its Articles of Incorporation were amended as set out in the quoted portion of request (a).

(c) That on the army transport General Ballou, which left New York City on November 27, 1948, the drug Dramamine, referred to in paragraph 3 of the stipulation herein filed, was tested by the United States Army under actual rough weather conditions. This test was called "Operation Seasickness."

(d) Subsequent to the completion of the test referred to in request (c) and prior to 1950 the plaintiff published and mailed to prospective purchasers of the drug, Dramamine, a pamphlet entitled "Opera-
[fol. 30] tion Seasickness" and on page 14 of that pamphlet the following statements were made:

> Dramamine is a distinct chemical entity recently developed in the Research Laboratories of G. D. Searle & Co.
>
> • • • •
>
> The introduction of Dramamine and Hydryllin represent simply two recent illustrations of a research policy which dates back many years in the progress of G. D. Searle & Co.
>
> • • • •
>
> (If the plaintiff feels that this quote is misleading as out of context the defendants suggest that in its answer to this request the plaintiff add whatever other language it feels cures that problem.)

(e) The chemical drug compounds known as Dramamine and Banthine, referred to in paragraph 3 of the stipulation herein filed, were not in existence prior to their being prepared by man through experiments with various chemical formulas.

(The word "prepared" is to have the same meaning in this request as it has in paragraph 3 of the stipulation herein filed.)

R. Tieken,
*United States Attorney, Attorney for the Defendants.*

Proof of service
(omitted in printing)

[fol. 31] IN THE
UNITED STATES DISTRICT COURT

• • • •

REQUEST FOR ADMISSIONS UNDER RULE 36—Filed March 23, 1959

The plaintiff, G. D. Searle & Co., requests the defendants John T. Jarecki and Ernest J. Sauber, within ten (10) days after service of this request, to make the following admissions for the purpose of this action only and subject to all pertinent objections to admissibility which may be made:

1. That the following statement is true: On or about July 21, 1955, the Internal Revenue Service transmitted to plaintiff a copy of a Revenue Agent's report rejecting the plaintiff's claims for refund of excess profits taxes for 1950 and 1951 under Section 456 of the Internal Revenue Code of 1939. In this report the following was stated:

> "The word discovery, it seems could be used to describe the introduction of at least one of the drugs, namely Dramamine, considered here."

2. That the following statement is also true: On July 18, 1950, E. C. Wright, the Internal Revenue Agent in Charge at Chicago, Illinois, sent plaintiff a "30-day" letter which concluded that plaintiff was not entitled to World War II excess profits tax relief for the calendar years 1941 to 1944, inclusive, under Section 722 of the Internal Revenue Code of 1939. Enclosed with such letter was a copy of a Revenue Agent's report dated April 9, 1950, which included the following statements of fact and conclusions with respect to drugs manufactured and sold by plaintiff:

"Aminophyllin:

"Aminophyllin was presented to the American Pharmaceutical Association meetings at Baltimore, [fol. 32] Maryland, May 5-10, 1930 by P. W. Schmitt of the Searle Laboratories.

"According to the Council of Pharmacy and Chemistry of the American Medical Association—'Aminophyllin has the action and uses of theophyllin and theophyllin sodio acetate over which it has the advantage of greater solubility. Like these it has a diuretic action, produces myocardial stimulation and occasionally may be useful in relieving the pain in coronary disease.' (From the publication—New and Non-Official Remedies—1934 of the A. M. A.)

"In 1934 New and Non Official Remedies, the Council on Pharmacy and Chemistry listed the following products and manufacturers under the heading theophyllin:

Aminophyllin—Pharmedic * * * No patent or trademark.
Aminophyllin—Searle * * * No patent or trademark.
Metaphyllin —Byk Guldenwerke, Chemsche Fabrick, Berlin, Germany, Distributors Adolph Hurst and Company, N. Y., N. Y. (Discontinued in 1936 by the A. M. A. Council).

"1934 was the first year that Searle's Aminophyllin was accepted by the American Medical Association's Council on Pharmacy and Chemistry. In 1936 Dubins Aminophyllin was accepted by the American Medical Association. More and more companies entered the Aminophyllin field from 1936 on. A study of the number of companies selling Aminophyllin up to 1941 is shown by Exhibit C. From 5 companies listed as suppliers in 1935 the list grew to 13 in 1939 and 24 in 1941. This list does not attempt to review all products with a theophyllin base which would have a similar therapeutic use.

"Sales pamphlets of the G. D. Searle Company relating to aminophyllin were available as early as 1930 titled 'Aminophyllin in the treatment of Cardiac Disease.' In 1932 the trade received sales lit-
[fol. 33] erature from G. D. Searle and Co. called 'A Modern Conception of Rational Drug Treatment in Cardiac Conditions Associated with Pain.' The tax-

payer's claim, page 7 erroneously indicates the basic chemical was developed in 1933.

"In 1933 the company offered three forms of aminophyllin, i. e., two sizes of ampuls and one size of tablets. In 1935 aminophyllin in powder form was added. In 1936 two sizes of tablets of aminophyllin with phenobarbital and one size tablet of aminophyllin with phenobarbital and one size tablet of aminophyllin with potassium iodide were added to the four forms of aminophyllin previously offered. The 1939 catalogue lists another size of aminophyllin ampul. By 1941 nine dosages of aminophyllin, two dosages of aminophyllin with phenobarbital and one form of aminophyllin with potassium iodide, or a total of twelve aminophyllin items were offered for sale.

"The sales of aminophyllin, all forms, was presented by the claim in dollar amount only. The product in relation to total dollar sales of the taxpayer from 1934, the year of American Medical Association approval, is as follows:

G. D. Searle & Co.

Aminophyllin

| Year | Amount | Per cent of total Company sales |
|---|---|---|
| 1934 | $137,361 | 19.8 |
| 1935 | 208,120 | 22.3 |
| 1936 | 256,887 | 23.0 |
| 1937 | 264,435 | 18.7 |
| 1938 | 327,934 | 21.0 |
| 1939 | 906,446 | 23.6 |

"Considering all the above facts carefully it appears that aminophyllin was introduced by G. D. Searle in 1930. By 1935 the product had reached normal in relation to the company's base period sales.

[fol. 34] "Conclusion:

"Aminophyllin does not qualify as a new product because it was not introduced immediately prior to the base period.

"Metamucil:

"This product, introduced in May 1934, was described in the taxpayer's catalogue of 1935 as 'the purified and concentrated vegetable mucilloid prepared from the seed of Plantago Ovata (Forsk), held in dispersion with a specially prepared milk powder.'

"This product is essentially in the laxative group of remedies. However, due to its special application, Exhibit D lists only colloidal and fiber group remedies designed primarily to supply or enhance the residue of the fecal mass and yet not bring about undue irritation to the colon. Including Psyllium seed in both 1935 and 1939 the number of similar products apparently about doubled in the four year period.

"The sales of the product by year is scheduled as follows for G. D. Searle & Co.

| Year | Amount | Per cent of total Company sales |
|---|---|---|
| 1934 | $ 65,981 | 9.5 (7 months) |
| 1935 | 181,495 | 19.5 |
| 1936 | 223,758 | 20.0 |
| 1937 | 332,073 | 23.5 |
| 1938 | 359,134 | 22.9 |
| 1939 | 370,207 | 21.5 |

"It seems that Metamucil attained maturity in relation to company sales much quicker than aminophyllin. This is inherent in the nature of the two products. Remedies for cardiac condition would advance as knowledge of their therapeutic effect broadened and evidences of unpleasant or dangerous propensities were discounted. However psyllium seed was well known to be a harmless laxative. Certainly a refine-

ment of this natural laxative could be adaptable to faster sales development than cardiac remedies.

[fol. 35] "However, the product was not introduced immediately prior to the base period so can not be a qualifying factor. The Tax Court, in Monarch Cap Screw and Manufacturing Company, *supra*, said 'Even if the increase in the type or quantity of articles manufactured may be considered a change in the character of the business as defined in the statute such change took place in 1934 and not during or immediately prior to the base period.' Also *Acme Breweries* v. *Comm*, *supra*.

"Floraquin:

"In June 1936 Floraquin appeared in the sales picture of the taxpayer. Initial literature was aimed at the treatment of leukorrhea. The 1936 catalogue also stated the product was adaptable to specific treatment of trichmona vaginalis. Later sales pamphlets were aimed at this specific disease.

"The essential ingredient of Floraquin is Diodoquin. Floraquin is 1½ gr. of diodoquin, lactose and specially prepared anhydrous dextrose adjusted by acidulation with boric acid to the proper hydrogen concentration for re-establishing the normal acidity and bacterial flora.

"Diodoquin (5-7 diodo-8-hydroxyquinoline) was also first listed in 1936 by the G. D. Searle & Co. catalogue. Diodoquin and Floraquin are chemically related to Chiniofon which in 1936 was sodium iodohydroxyquinolinesulfonate. Diodoquin and Chiniofon are protozoacides for the intestinal tract. Chiniofon was introduced substantially before the base period, probably about 1930.

"The taxpayer had other products which had a similar therapeutic effect as Floraquin. A product called Suppositones was for the palliative treatment of similar female diseases. Though no other similar remedy of the taxpayer used the hydroxyquinoline base it was a reasonable development of the protozoacide Chiniofon and merely extended the line of the taxpayer's products for female diseases.

[fol. 36] Floraquin

| Year | Amount | Per cent of total Company sales |
|---|---|---|
| 1936 | $ 41,123 | 3.7 (7 months) |
| 1937 | 96,469 | 6.8 |
| 1938 | 97,818 | 6.3 |
| 1939 | 120,972 | 7.0 |
| 1940 | 164,925 | 8.7 |
| 1941 | 158,161 | 6.8 |

"Remedies for trichomonas vaginalis vaginitis as listed in the 1941 edition of the Modern Drug Encyclopedia and Therapeutic Guide are compared in Exhibit E. The increase of remedies particularly adaptable to trichamonas vaginalis increased from 11 in 1935 to 16 in 1939 and 18 in 1941. This list is not intended to be all inclusive but is furnished to show that an increasing number of products were aimed at this type of disease by the pharmaceutical industry.

"Ketochol:

"Ketochol is described by the taxpayer's catalogue as a combination of the oxidized or keto form of bile acids (cholic desoxycholic, chenodesoxycholic and lithocholic acids) normally present in human bile. Ketochol was considered by the trade to be composed largely of dehydrocholic acid.

"The Modern Drug Index and Therapeutic Guide 1941 Edition lists Ketochol as a choloretic and distinguishes between choloretics and cholagogues. However, the 1934 Edition made no such distinction therefore the 1941 Edition was used to obtain a list of products of similar therapeutic use as shown by Exhibit F. However, a 1945 Edition of Gould's Medical Dictionary defines both cholagogue and choloretic as tending to increase the flow of bile. In the 1930's bile remedies were often used for their laxative effect too. Among the Searle products which affected the bile and or gall bladder are the following with a brief description of their suggested usage from the taxpayer's catalogue of 1935.

[fol. 37] "Cas-ca-bile—(Searle)—for use as a Cholagogue, digestive stimulant and a mild cathartic. Also retained in 1939 catalogue.

"Cholphenolate—(Searle)—* * * is indicated in any condition associated with deficient secretion of bile and is particularly effective in the treatment of chronic constipation. Also listed in the 1939 catalogue.

"Magnesium Sulfate Enteric Coated—Used in condition where non-surgical drainage of the gall bladder is indicated and as a laxative. Retained by 1939 catalogue.

"Oxgall Salol Compound—Suggested in the treatment of intestinal indigestion, catarrhal condition of the intestines and deficient biliary secretion. Listed in 19 ' catalogue.

"Chronanthus Compound: Hepatic stimulant and cathartic for inactivity of the liver. Dropped from 1938 catalogue listing.

"Ketochol, first listed in the 1938 catalogue—'A definite choloretic action in stimulating the liver cells to secrete an increased quantity of bile, producing increased activity of the entire biliary apparatus including the gall bladder, facilitates drainage and overcomes bile stasis." This product was brought out in February 1937.

"In August 1939 the Journal of the American Medical Association announced that Ketochol was determined to be non-acceptable as a New and Non Official Remedy by the council on Pharmacy and Chemistry.

"The dollar sales volume of Ketochol and its relation to total sales of the company are as follows:

| Year | Amount | Per cent of total Company sales |
|---|---|---|
| 1937 | $116,322 | 8.2 (11 months) |
| 1938 | 229,157 | 14.7 |
| 1939 | 293,388 | 17.0 |
| 1940 | 286,536 | 15.2 |
| 1941 | 298,131 | 12.8 |
| 1942 | 300,958 | 11.7 |

[fol. 38] "This schedule shows 1939 to be the year of maximum development in relation to total company sales.

"It is apparent from the number of biliary remedies that Ketochol is an extension of the company's line of products for treatment of liver and gall bladder diseases.

"Exhibit F shows the increasing number of products of a similar therapeutic use increasing from 8 in 1935 to 18 in 1939, to 26 competing products in 1941.

"The Bulletin on Section 722 (G.P.O. Issue, Page 50) under a difference in products or services furnished states: 'Such addition or elimination (of products) however, must represent more than a usual or customary event in the type of business in which the taxpayer is engaged.' * * * Moreover, a product or service must be substantially different from the products or services previously furnished; mere improvement does not constitute a difference. The addition or elimination of a new product to or from a line of varied products, as where a novelty store selling hundreds of items adds several new lines, will not ordinarily be held to constitute a difference in products furnished.'

"Ketochol was another item added to some 350 Pharmaceutical items in the line in 1937. Ketochol was another biliary or liver remedy supplementing existing catalogue items of the claimant. Therefore, Ketochol fails to qualify as a new product.

"Other Research Products:

"The other 'research' products, and their year of introduction, included in the taxpayer's chart on page 6 of the claim, *supra*, are Iodochlorol—1934, Sylnasol—1935, Diodoquin—1936, and Furmerane—1941. Dollar sales volume by year to agree with the claim are as follows:

[fol. 39]

| Year | * Iodo-chlorol | ** Sylnasol | Diodoquin | Fumerane | Total per claim | Total Corrected for Notes Below |
|---|---|---|---|---|---|---|
| 1934 | $ | $ | $ | $ | $ | $ |
| 1935 | 5,958 | | | | 5,958 | 12,261 |
| 1936 | 10,432 | 15,928 | E 4,000 | | 30,360 | 34,360 |
| 1937 | 12,355 | 17,543 | E 8,000 | | 32,898 | 45,898 |
| 1938 | 13,551 | 18,762 | E 12,000 | | 44,223 | 48,223 |
| 1939 | 14,694 | 18,603 | 20,521 | | 53,711 | 53,711 |
| 1940 | 17,278 | 17,643 | 20,539 | | 55,460 | 55,460 |
| 1941 | 33,159 | 23,479 | 23,879 | 10,762 | 91,279 | 80,517*** |

* Listed in 1934 catalogue.

** Formerly "Sylasol". Sales totaled $6,303.00 for last quarter of 1935.

*** Eliminating 1941 product.

E Corrected estimate based on Floraquin should be approximately 1936—$8,000, 1937—$16,000, 1938—$16,000. These figures are used in column 7.

"The percentage of sales of other Research Products to total sales of the company are as follows:

| Year | Corrected Amount as Above | % of Total Company Sales |
|---|---|---|
| 1935 | $ 12,261 | 1.32 |
| 1936 | 34,360 | 3.07 |
| 1937 | 45,898 | 3.25 |
| 1938 | 48,223 | 3.08 |
| 1939 | 53,711 | 3.11 |
| 1940 | 55,460 | 2.94 |
| 1941 | 80,577 | 3.44 |

"These products obtained substantial maturity in 1936 in relation to total sales so that further consideration as qualifying factors is not deemed necessary in this report.

"To summarize conclusions relative to research products or new products:

"Aminophyllin does not qualify as new product or a research product of the new management as it was

developed prior to 1933 and was not a change immediately prior to the base period.

"Metamucil and Iodochlorol were developed after 1933 but do not qualify as a new product introduced immediately prior to the base period.

[fol. 40] "Floraquin and Diodoquin were of a similar chemical background. Both products were of a class similar to those previously marked by the company.

"Ketochol was a therapeutic remedy of a class already marketed by the company.

"The taxpayer fails to show a change in the character of the business, either through management, marketing or research policies, which were made during or immediately prior to the base period and which resulted in an inadequate standard of normal earnings for the entire base period."

Sidley, Austin, Burgess & Smith,
*Attorneys for plaintiff.*

Proof of Service (omitted in printing)

IN THE UNITED STATES DISTRICT COURT

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PLAINTIFF'S ANSWER TO REQUEST FOR ADMISSIONS—Filed March 30, 1959

Plaintiff, G. D. Searle & Co., through its Treasurer, Kenyon D. Bowes, being first duly sworn, states in reply to the request by defendants for admissions, dated March 19, 1959:

1. Admits the accuracy of the documents described in the first five paragraphs of the defendant's request for admissions, but states that Exhibit C attached to the defendants' request was submitted by the plaintiff to the Internal Revenue Service during 1950.

[fol. 41] 2. Admits the truth of the statements of fact contained in paragraph 6(a) and (b) of the request, but states that the quoted portion of Article Four was only part of the revisions of plaintiff's Articles of Incorporation made at the time of its first public stock offering. The quoted excerpt from Article Four was merely one of several revisions made in 1950 to modernize Searle's Articles of Incorporation and did not reflect any change in its business. Moreover, plaintiff's Board of Directors voted to amend the Articles of Incorporation on January 5, 1950, rather than on January 16, 1950.

3. Admits the truth of the statement of fact contained in paragraph 6(c), (d) and (e) of the request.

G. D. Searle & Co.,
*Plaintiff,*

By Kenyon D. Bowes,
*Treasurer.*

• • • •

Proof of Service (omitted in printing)

[fol. 42] IN THE
UNITED STATES DISTRICT COURT

• • • • •

OBJECTIONS OF THE DEFENDANTS TO THE PLAINTIFF'S REQUESTS FOR ADMISSIONS—Filed March 31, 1959

Now come the defendants in the above case and request the Court to grant an Order relieving them from replying to the plaintiff's Requests for Admissions served upon them on March 23, 1959, as the matters therein referred to could neither constitute evidence nor lead to evidence in this proceeding. Furthermore, and more explicitly, both Requests 1 and 2 refer to alleged statements by employees or former employees of the Internal Revenue Service concerning matters peculiarly within the personal knowledge of the plaintiff and not within the personal knowledge of those employees. Therefore, such statements are, even if interpreted as admissions, admissions of opinions, not of facts, and as such they are totally irrelevant.

R. Tieken,
*United States Attorney.*

IN UNITED STATES DISTRICT COURT

• • • • •

MOTION OF DEFENDANTS FOR SUMMARY JUDGMENT—Filed March 31, 1959

Now come the defendants, John T. Jarecki and Ernest J. Sauber, by and through R. Tieken, United States Attorney in and for the Northern District of Illinois, and move the Court for an Order granting this Motion and dismissing the instant action with prejudice and with costs assessed against the plaintiff.

This motion is predicated upon the pleadings, stipula-
[fol. 43] tion of facts and the plaintiff's responses to the defendants' Requests for Admissions of Fact and the genuineness of documents, all of which are part of the record in this case and upon the proposition of law that

the word "discovery" used in Section 456(a)(2)(B), Internal Revenue Code of 1937, as amended, does not include products prepared through "research and development", but only refers to products which are already in existence and thus susceptible to being discovered such as certain natural resources.

R. Tieken,
*United States Attorney.*

IN THE UNITED STATES DISTRICT COURT

• • • •

**FINDINGS OF FACT AND CONCLUSIONS OF LAW—MAY 11, 1959**

The above case came on to be heard on motion of the defendants for an order granting summary judgment in their favor.

The plaintiff was represented by Walter J. Cummings, Jr., of Sidley, Austin, Burgess and Smith, and the defendants were represented by William F. Kolbe, Attorney, Department of Justice, Harvey M. Silets, Assistant United States Attorney, and R. Tieken, United States Attorney.

The court after carefully considering the pleadings, the Stipulation of Facts, certain Requests for Admission served on the plaintiff by the defendants, and the answers thereto, certain requests for admissions served on the defendants by the plaintiff and the answers thereto, the briefs of the parties and the arguments of counsel, finds the following facts to be true and uncontroverted and based thereon reaches the following conclusions of law.

[fol. 44] FINDINGS OF FACT

1. The plaintiff is a Delaware corporation with its principal place of business in Skokie, Illinois. It brings this action to recover excess profits taxes in the total amount of $3,638,238.82, plus interest thereon, which amount it alleges was erroneously and illegally assessed

and collected by the defendants for the calendar years 1950, 1951 and 1952.

2. The plaintiff is in the business of manufacturing and marketing ethical drugs and derives income therefrom.

3. Prior to 1950, and over a period of more than twelve months, the plaintiff incurred expenditures which resulted in the preparation and manufacture of two pharmaceuticals whose trade names are, respectively, Banthine and Drainamine.

4. During the years here involved, 1950, 1951 and 1952, plaintiff derived income from sales of Banthine and Dramamine. It is this income which the plaintiff claims constituted abnormal income within the meaning of Section 456(a)(2). Internal Revenue Code of 1939. This claim, which is controverted by the defendants, is the sole basis of the complaint in this case.

5. Both the drugs Banthine and Dramamine were developed from and arose out of research activities conducted by the plaintiff prior to 1950.

6. The chemical drug compounds, Banthine and Dramamine, were not in existence prior to their being prepared by the plaintiff through experiments with various chemical formulas.

7. Plaintiff applied for and received product patents on the following drugs that it marketed during the 1940-1953 period:

| Product | Filed | Granted |
|---|---|---|
| Pavatrine | 4-20-40 | 11-18-41 |
| Dramamine | 3-18-40 | 2-28-50 |
| Banthine | 5-10-52 | 11-17-53 |

[fol. 45] Its application for such patents were denied on the following:

| Product | Filed | Abandoned |
|---|---|---|
| Hydryllin | 4-29-47 | 7-10-52 |
| Tetrathione | 8- 7-42 | 4-30-48 |

8. Two contentions are made by the plaintiff in support of its assertion that income attributable to its sales of Banthine and Dramamine is "abnormal income" within the meaning of Section 456(a)(2), Internal Revenue Code of 1939; first, it asserts that both of these drugs were "discoveries" within the meaning of Section 456(a)(2)(B) and then alternatively, it asserts that even if this is not so, such income is subject to classification as "abnormal income" under the last sentence of Section 456(a)(2) and the Treasury Regulations promulgated thereunder.

9. The defendants in moving this Court for a summary judgment in their favor contend that the word "discovery" as used in Section 456(a)(2) does not include a product created or developed through research and that as the drugs Banthine and Dramamine are products arising out of the plaintiff's research they are not discoveries within the meaning of Sections 456(a)(2)(B) and consequently income arising from their sale does not qualify for the special tax treatment set out in Section 456(a)(2).

10. This action was brought pursuant to 28 U.S.C. 1340 and the Court has jurisdiction thereof.

[fol. 46] Conclusions of Law

1. Any finding of fact which may be considered a conclusion of law is hereby concluded as a matter of law.

2. In enacting Section 456(a)(2)(B), Internal Revenue Code of 1939, Congress set out the type of income therein defined as abnormal. It stated as follows:

> (B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than twelve months; or

The plaintiff asserts that its income from the sales of Banthine and Dramamine is income resulting from a discovery. Regardless of how the word "discovery" may generally and often incorrectly, be used, it does not encompass the preparations of these drugs. They are products arising out of research and development and as such

specifically prohibited by Congress from being considered discoveries within the meaning of Section 456(a)(2)(B). See: S. Rep. 2679, 81st Cong., 2d Sess. (1951-1 Cum. Bull. 240, 249.

3. The Treasury Regulations promulgated pursuant to the last sentence of Section 456(a)(2), Internal Revenue Code of 1939 do not support the plaintiff's position. Rather they support the defendant's position. Treasury Regulations 130, Section 40-456-2(b) (as amended by T. D. 6026, 1953-2 Cum. Bull. 235) provide as follows:

> "(B) Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, [fol. 47] and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)."

Clearly, by this regulation, income from the sale of tangible property arising out of research and development may not be classified as abnormal.

The last sentence of this regulation is not applicable to the present case.

The income which the plaintiff received from its sales of Banthine and Dramamine during 1950, 1951 and 1952 may not be classified as "abnormal income" under Section 456(a)(2) and consequently the plaintiff is not entitled to any relief in this action.

Therefore, the defendants' motion for summary judgment shall be granted and a judgment order entered accordingly.

Enter:

M. L. Igoe,
*United States District Judge.*

Date: May 11, 1959.

[fol. 48] IN THE
UNITED STATES DISTRICT COURT

* * * * *

JUDGMENT ORDER—May 11, 1959

In accordance with the Findings of Fact and Conclusions of Law entered in the above case,

It is Ordered that the complaint herein filed is dismissed, with prejudice, costs to abide the issue.

Enter:

M. L. Igoe,
*United States District Judge.*

Date: May 11, 1959.

[fol. 49] IN THE
UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS,
EASTERN DIVISION

No. 57 C 1717

G. D. SEARLE & Co., a Corporation, PLAINTIFF

*vs.*

JOHN T. JARECKI, former Collector of Internal Revenue, and ERNEST J. SAUBER, former Collector of Internal Revenue and former District Director of Internal Revenue, DEFENDANTS

NOTICE OF APPEAL—Filed July 10, 1959

Notice is hereby given that G. D. Searle & Co., plaintiff, hereby appeals to the United States Court of Appeals for the Seventh Circuit from the summary judgment entered for defendants on May 11, 1959.

Edwin C. Austin,
Middleton Miller,
Walter J. Cummings, Jr.,
11 South La Salle Street,
Chicago 3, Illinois.

Sidley, Austin, Burgess & Smith,
*Of Counsel.*

[fol. 50] United States of America, )
Northern District of Illinois, ) ss.

(Caption—57-C-1717)

CERTIFICATE OF MAILING
Omitted in Printing

[fol. 51] IN UNITED STATES DISTRICT COURT

* * * * *

STIPULATION RE RECORD—July 31, 1959

It is hereby stipulated by and between the parties pursuant to Rule 75 (o) of the Federal Rules of Civil Procedure, and Rule 12 (e) of the Rule of the United States Court of Appeals for the Seventh Circuit that the record on appeal herein shall consist of the following items:

(1) Complaint filed October 16, 1957.
(2) Answer filed December 16, 1957.
(3) Defendants' first interrogatories to plaintiff filed May 29, 1958.
(4) Defendants' second interrogatories to plaintiff filed June 11, 1958.
(5) Plaintiff's answers to defendants' first interrogatories, filed June 13, 1958.
(6) Plaintiff's answers to defendants' second interrogatories, filed July 11, 1958.
(7) Stipulation of Facts filed February 16, 1959.
(8) Order of February 19, 1959, allowing plaintiff's motion for separate trial of the issues.
(9) Defendants' request for admissions under Rule 36 filed March 19, 1959, with Appendices thereto.
(10) Plaintiff's request for admissions under Rule 36, filed March 23, 1959.
(11) Plaintiff's answer to request for admissions, filed on March 30, 1959.
(12) Objections of the defendants to the plaintiff's requests for admissions, filed March 31, 1959.
(13) Defendants' motion for summary judgment, filed March 31, 1959.
(14) Transcript of oral argument before Judge Igoe on March 31, 1959.
[fol. 52] (15) Defendants' answer to plaintiff's request for admissions, filed April 2, 1959.
(16) Transcript of oral argument before Judge Igoe on April 28, 1959.
(17) Findings of Fact and Conclusions of Law with Judgment Order dismissing Complaint entered on May 11, 1959.

(18) Plaintiff's Notice of Appeal filed on July 10, 1959.
(19) This Stipulation.

Walter J. Cummings, Jr.,
*Attorney for Plaintiff-Appellant,*

R. Tieken,
*Attorney for Defendants-Appellees.*

Dated: July 31, 1959.

CLERK'S CERTIFICATE TO FOREGOING TRANSCRIPT.
Omitted in Printing

[fol. 53] • • • •

[fol. 54] IN THE
UNITED STATES DISTRICT COURT

• • • •

DEFENDANTS' ANSWERS TO PLAINTIFF'S REQUESTS FOR ADMISSIONS—Filed April 2, 1959

The defendants, having filed objections to the plaintiff's requests for admissions and these objections having been overruled, now answer said requests as follows:

1. Admit request Number 1.
2. Admit request Number 2.

R. Tieken,
*United States Attorney.*

[fol. 55] IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

SEPTEMBER TERM, 1959—JANUARY SESSION, 1960

No. 12747

G. D. SEARLE & Co., PLAINTIFF-APPELLANT

v.

JOHN T. JARECKI, former Collector of Internal Revenue, and ERNEST J. SAUBER, former Collector of Internal Revenue and former District Director of Internal Revenue, DEFENDANTS-APPELLEES

Appeal from the United States District Court for the Northern District of Ilinois, Eastern Division

OPINION—January 27, 1960

Before MAJOR, SCHNACKENBERG and CASTLE, *Circuit Judges.*

CASTLE, *Circuit Judge.* G. D. Searle & Co., plaintiff-appellant, referred to as taxpayer, instituted this action to recover excess profits taxes in the total amount of $3,638,238.82, plus interest, which amount it alleges was erroneously and ilegally assessed and collected by the Government for the calendar years 1950, 1951, and 1952. The District Court dismissed the suit on motion for summary judgment filed by the Government. The taxpayer appealed contending the granting of summary judgment was error in that it was based on an erroneous interpretation of the pertinent Internal Revenue Code provision and that a genuine issue of material fact existed.

[fol. 56] The pleadings, a stipulation of facts, and answers to interrogatories and requests for admissions disclose that the taxpayer is engaged in the manufacture and marketing of ethical drugs. Prior to 1950, and over a period of more than twelve months, the taxpayer incurred expenditures which resulted in the preparation and manufacture of two pharmaceuticals with the trade names of Banthine and Dramamine. During the years here involved the taxpayer derived income from sales of these drugs. Both were developed from and arose out of research activities conducted by the taxpayer before 1950. These chemical drug compounds were not in existence prior to their being prepared through experiments with various chemical formulas. The taxpayer applied for and received patents on both products.

The taxpayer claimed that the income from the sales of Banthine and Dramamine constituted abnormal income within the meaning of Sec. 456 (a) (2) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed., Sec. 456).[1]

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[1] Insofar as pertinent Sec. 456 provides:

§456. Abnormalities in income in taxable period—

(a) Definitions.

For the purposes of this section—

(1) Abnormal income.

The term "abnormal income" means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) Separate classes of income.

Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes,

[fol. 57] Section 456 is designed to afford relief from the impact of excess profits taxes in certain situations which give rise to abnormally high income during the taxable year.

The taxpayer asserted that the income from the drugs Banthine and Dramamine qualified as income resulting from "discovery" within the class of income described in Sec. 456 (a) (2) (B) as:

> "Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months;"

And, alternatively, the taxpayer asserted that such income is subject to classification as abnormal income pursuant to the Treasury Regulations [2] promulgated under the provision of Sec. 456 that:

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or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

[2] Treasury Regulations 130, Sec. 40.456-2 (b), as amended by T.D. 6026 (1953-2) Cum. Bull. 235:

(b) Other income, not within a class described in subparagraphs (A)-(D) of section 456 (a) (2), to which section 456 is applicable, may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456 (a) (2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456 (a) (2) (D).

"The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary".

The District Court held that the meaning of the word "discovery" as used in the statute, did not encompass the preparation of Banthine and Dramamine because they are products arising out of research and development, and that the Treasury Regulation, to which reference has been made, is not applicable.

The common accepted meaning of the word "discovery" includes "Finding out or ascertaining something previously [fol. 58] unknown or unrecognized; as Curie's *discovery* of radium" (Webster's New International Dictionary (Unabridged 2d ed.) p. 745). We do not deem the maximum *noscitur a sociis* applicable. The wording of subparagraph (B) of the statute indicates that each word should be given significance independently of the others. It refers to "exploration, discovery, or prospecting, or any combination of the foregoing". The context in which the word appears suggests no reason to limit or qualify its commonly accepted meaning. That the statute herein involved omitted a provision of a similar World War II Excess Profits Tax Act which in defining abnormal income included that resulting from "research, or development of tangible property" does not in our opinion serve to narrow the scope of the word "discovery" as employed in the Internal Revenue Code provision here under consideration. The elimination of "research" and "development" as factors qualifying income for abnormal income classification served the Congressional objective of plugging "a potention loop-hole of major dimensions".[3] And, absent the element of discovery, income resulting from research or development does not by reason of the latter factors qualify for treatment as abnormal income. But the plugging of the loophole which existed under a former Act because of the use of the unqualified terms "research" and "development" does not require that the word "discovery" which the Congress saw fit to re-employ in the latter enact-

[3] H. Rep. No. 3142, 81st Cong., 2d Sess., p. 13 (1951-1 Cum. Bull. 187, 189).

ment be regarded as having taken on the limited and qualified meaning the Government would ascribe to it. Neither the context of Sec. 456 nor the legislative history demonstrates that the term "discovery" was intended to describe only the discovery of that which is already in existence *i.e.* natural resources. If Congress had intended to limit the meaning of "discovery" it would have been a simple matter for it to have expressly done so.

It is our opinion that income resulting from discovery is not under the terms of subparagraph (B) of the statute precluded from classification as abnormal income merely because research or development may have occasioned, or have been factors which contributed to, the discovery. It [fol. 59] is unnecessary to consider the argument advanced by the taxpayer concerning the application of the Treasury Regulation.

We conclude that the District Court erred in its interpretation of the statute and in granting summary judgment for the Government. A genuine issue of material fact existed as to whether Banthine and Dramamine were actually discoveries. Nothing we have said should be regarded as indicating any expression of opinion on the factual issue.

The judgment of the District Court is reversed and the cause remanded for further proceedings not inconsistent with this opinion.

REVERSED AND REMANDED.

• • • •

[fol. 60] IN UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

• • • •

No. 12747

G. D. SEARLE & CO, PLAINTIFF-APPELLANT

v.

JOHN T. JARECKI, former Collector of Internal Revenue, and ERNEST J. SAUBER, former Collector of Internal Revenue etc., DEFENDANTS-APPELLEES

---

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division

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JUDGMENT—January 27, 1960

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This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, REVERSED, and that this cause be, and it is hereby REMANDED to the said District Court for further proceedings not inconsistent with the opinion of this Court filed this day.

[fol. 61] IN UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

(Title Omitted)

ORDER DENYING MOTION FOR LEAVE TO FILE PETITION FOR REHEARING—April 28, 1960

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This matter comes before the Court on the motion of defendants-appellees for leave to file a petition for rehearing out of time and documents tendered therewith, and the memorandum of plaintiff-appellant in opposition to said motion.

On consideration whereof, IT IS HEREBY ORDERED that the said motion for leave to file petition for rehearing out of time be, and the same is hereby, DENIED.

[fol. 62] UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

* * * *

Clerk's Certificate to foregoing transcript omitted in printing

[fol. 63] SUPREME COURT OF THE UNITED STATES

• • • •

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI—April 22, 1960

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UPON CONSIDERATION of the application of counsel for petitioner(s),

IT IS ORDERED that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including June 25th, 1960.

/s/ Tom Clark
*Associate Justice of the Supreme Court of the United States*

Dated this 22 day of April, 1960.

[fol. 64] SUPREME COURT OF THE UNITED STATES

No. 151, October Term, 1960

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JOHN T. JARECKI, Former Collector of Internal Revenue, et al., PETITIONERS

vs.

G. D. SEARLE & Co.

---

ORDER ALLOWING CERTIORARI. October 10, 1960.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Seventh Circuit is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1960 574975 595

COPY

Office Supreme Court, U.S.
FILED
JUN 16 1960
JAMES R. BROWNING, Clerk

No. 151

# In the Supreme Court of the United States

OCTOBER TERM, 1959

JOHN T. JARECKI, former Collector of Internal Revenue, ET AL., PETITIONERS

*v.*

G. D. SEARLE & CO.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

J. LEE RANKIN,
*Solicitor General,*
CHARLES K. RICE,
*Assistant Attorney General,*
HARRY MARSELLI,
NORMAN H. WOLFE,
*Attorneys,*
*Department of Justice,*
*Washington 25, D. C.*

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## CITATIONS

Cases:


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# In the Supreme Court of the United States

OCTOBER TERM, 1959

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No.

JOHN T. JARECKI, former Collector of Internal Revenue, ET AL., PETITIONERS

*v.*

G. D. SEARLE & CO.

---

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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The Solicitor General, on behalf of John T. Jarecki, former Collector of Internal Revenue, and Ernest J. Sauber, former Collector of Internal Revenue and former District Director of Internal Revenue, petitions for a writ of certiorari to review the judgment of the Court of Appeals for the Seventh Circuit in this case.

### OPINIONS BELOW

The opinion of the District Court (R. 43-47)[1] is not officially reported. The opinion of the Court of Appeals (Appendix A, *infra*, pp. 8-13) is reported at 274 F. 2d 129.

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[1] Record references are to the Appendix to the brief for the taxpayer in the Court of Appeals.

## JURISDICTION

The judgment of the Court of Appeals was entered on January 27, 1960 (Appendix A, *infra*, p. 14). On April 22, 1960, by order of Mr. Justice Clark, the time within which to file a petition for a writ of certiorari was extended to and including June 25, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

## QUESTION PRESENTED

Whether the income received by the taxpayer from the sale of certain patented drugs resulted from "discovery" within the meaning of Section 456(a)(2)(B) of the Internal Revenue Code of 1939, so as to qualify for the Korean War excess profits tax relief as "abnormal income."

## STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations are set forth in Appendix C, *infra*, pp. 29-32.

## STATEMENT

The facts are not in dispute. The taxpayer, which was engaged in manufacturing and marketing ethical drugs, incurred research expenditures prior to 1950, and over a period of more than twelve months, which resulted in the preparation and manufacture of two pharmaceuticals, with the trade names of "Banthine" and "Dramamine". They were not in existence prior to this work and the taxpayer received patents on both. (R. 44; Appendix A, *infra*, p. 9.) During the years here involved, it derived income from sales of these drugs. (R. 44; Appendix A, *infra*, p. 9.)

In this action, the taxpayer sought to recover excess profits taxes aggregating $3,638,238.82 (plus interest) upon the theory that its income from the sales of Banthine and Dramamine constituted "abnormal income" within the meaning of Section 456(a)(2) of the Internal Revenue Code of 1939. (R. 44-45; Appendix A, *infra*, pp. 9-10.) Upon the Government's motion for summary judgment, the District Court dismissed the complaint. It held that the taxpayer's income from sales of Banthine and Dramamine was not income resulting from "exploration, discovery, or prospecting" within the meaning of Section 456(a)(2)(B), but income from the sale of products arising out of research and development and, as such, "specifically prohibited by Congress"—as a departure from a corresponding relief provision as to World War II excess profits taxes, Section 721(a)(2)(C)—from, being considered as income accorded relief under the Korean War law, in Section 456(a)(2).[2] (R. 46-47.)

The Court of Appeals, taking the view that the income in question could qualify for relief as income from "discovery" under Section 456(a)(2)(B), reversed and remanded the case for trial, because in its view a "genuine issue of material fact existed as to whether

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[2] The District Court further held that, as income from the sale of tangible property arising out of research and development, the taxpayer's income from the sale of the drugs in question may not be classified as abnormal under Treasury Regulations 130, Section 40.456-2(b) (as amended by T.D. 6026, 1953-2 Cum. Bull. 235, Appendix C, *infra*, pp. 31-32), promulgated pursuant to the last sentence of Section 456(a)(2). (R. 46-47.) In view of its construction of Section 456(a)(2)(B), the Court of Appeals found it unnecessary to consider this. (Appendix A, *infra*, pp. 12-13.)

Banthine and Dramamine were actually discoveries." (Appendix A, *infra*, p. 13.)[3]

REASONS FOR GRANTING THE WRIT

The sole question presented is one of statutory interpretation. The Court of Appeals for the First Circuit in *Polaroid Corp.* v. *Commissioner* (decided May 3, 1960) (Appendix B, *infra*, pp. 15-28) has expressly disagreed with the Seventh Circuit's decision here. We have been advised that the taxpayer in *Polaroid* will seek review by this Court, and the Government intends not to oppose the petition in that case.

1. The Seventh Circuit interpreted the word "discovery" in Section 456(a)(2)(B) of the Code[4] in accordance with the "common accepted meaning of the word" as set forth in the dictionary, which it regarded as broad enough to include anything which is the result of research and development. (Appendix A,

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[3] Subsequently, on April 22, 1960, the Government filed a motion with the Court of Appeals for leave to file a petition for rehearing, out of time, for the purpose of presenting more extensive legislative history of the Code section here involved and its antecedents, believed to be of controlling significance. That motion was denied, on April 28, 1960.

[4] All Code references herein are to the 1939 Internal Revenue Code.

Section 456 provides that certain amounts of "abnormal income" which really are attributable to other years may (under the formula therein prescribed) be reallocated to such other years so as to afford relief from the burden of the excess profits tax in the year in which they actually are received. In Section 456(a)(2) the term "abnormal income" is restricted to four classes, and the taxpayers in both this case and *Polaroid* assert that their income is within class (B)—

> Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months * * *.

*infra*, pp. 11-12.) In direct contrast, the First Circuit in *Polaroid* held that the word "discovery"—because of the context in which it is used in Section 456(a)(2)(B), and in view of the relevant legislative history and related statutory provisions—constitutes a term of art relating only to the mining industries. From the pertinent legislative history, the First Circuit concluded (Appendix B, *infra*, pp. 22-23) that the words "exploration, discovery, or prospecting" had already become "well-recognized words of art", having application only to the mining industries, at the time they were used in the World War II excess profits tax law in Section 721(a)(2)(C) (Appendix C, *infra*, pp. 30-31). There they had been used together with the phrase "research, or development of tangible property", but that phrase was, as the First Circuit pointed out, deliberately omitted from the corresponding provision of the Korean War law, Section 456(a)(2)(B). Further, the First Circuit noted, the pertinent Committee Reports[5] clearly establish that that omission was one of the "changes" intentionally made by Congress in the Korean War law, whereby it "redefined and restricted", in Section 456, "the types of income to which this special treatment [as "abnormal income", to be attributed to other years] was to be afforded." (Appendix B, *infra*, pp. 23-24.)[6]

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[5] H. Rep. No. 3142, 81st Cong., 2d Sess., p. 13 (1951-1 Cum. Bull. 187, 195); S. Rep. No. 2679, 81st Cong., 2d Sess., pp. 13-14 (1951-1 Cum. Bull. 240, 249).

[6] These changes were in keeping with the over-all new and drastically different approach to the granting of relief adopted in the Korean War law—generally discarding the highly discretionary and subjective provisions of the World War II law, and replacing them by provisions for a more objective system, operating automatically

In reaching the "opposite conclusion" from the Seventh Circuit,[7] the First Circuit specifically recognized the absence of any factual distinction between *Polaroid* and the instant case—characterizing this as "a case seemingly on all fours" with *Polaroid* "except that it came up on the granting of the government's motion for summary judgment of dismissal * * *." (Appendix B, *infra*, p. 20, fn. 8.)

2. The question in this case, and in *Polaroid*, presents an important problem in the administration of the relief provisions of the Korean War excess profits tax law—which are just now beginning to reach the appellate level in litigation, and can reasonably be expected to follow in increasing volume in the future.[8] The instant case and *Polaroid* represent the initial litigation concerning the applicability of the relief provisions of Section 456 of the Korean War law to income from sales of products resulting from inventions. By their nature, such controversies generally

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upon prescribed formulas. See H. Rep. No. 3142, 81st Cong., 2d Sess., pp. 16-17 (1951-1 Cum. Bull. 187, 197-198), and S. Rep. No. 2679, 81st Cong., 2d Sess., pp. 17-18 (1951-1 Cum. Bull. 240, 251-252).

[7] With respect to the point concerning the application of Treasury Regulations 130, Section 40.456-2, *supra*, not considered by the Seventh Circuit, the First Circuit held that the Commissioner was not obligated by Section 456 to grant relief on the basis of a classification, outside the statutory classes, suggested by the taxpayer and, further, that the applicable Regulations specifically exclude from the relief provisions income of the type for which the taxpayer in *Polaroid* (as the taxpayer in this case) sought relief. (Appendix B, *infra*, pp. 24-26.)

[8] The Korean War law did not contain any provision like Section 732(c), which made relief questions under the World War II law not reviewable by any court except the Tax Court.

involve very substantial amounts of tax.[9] Resolution of the conflict of decisions would avoid substantial future litigation.

## CONCLUSION

Certiorari should be granted.

Respectfully submitted,

J. LEE RANKIN,
*Solicitor General.*

CHARLES K. RICE,
*Assistant Attorney General.*

HARRY MARSELLI,
NORMAN H. WOLFE,
*Attorneys.*

JUNE, 1960.

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[9] This case and *Polaroid* alone involve close to $4,500,000 in taxes.

In addition, as the result of a preliminary search, the Internal Revenue Service informs us that there are pending administratively (or in the Tax Court) at least five other cases, involving approximately six million dollars in taxes.

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

SEPTEMBER TERM, 1959—JANUARY SESSION, 1960

No. 12747

G. D. SEARLE & CO., PLAINTIFF-APPELLANT,

*v.*

JOHN T. JARECKI, former Collector of Internal Revenue, and ERNEST J. SAUBER, former Collector of Internal Revenue and former District Director of Internal Revenue, DEFENDANTS-APPELLEES

Appeal from the United States District Court of the Northern District of Illinois, Eastern Division.

January 27, 1960

Before MAJOR, SCHNACKENBERG and CASTLE, *Circuit Judges.*

CASTLE, *Circuit Judge.* G. D. Searle & Co., plaintiff-appellant, referred to as taxpayer, instituted this action to recover excess profits taxes in the total amount of $3,638,238.82, plus interest, which amount it alleges was erroneously and illegally assessed and collected by the Government for the calendar years 1950, 1951, and 1952. The District Court dismissed the suit on motion for summary judgment filed by the Government. The taxpayer appealed contending the granting of summary judgment was error in that it was based on an erroneous interpretation of the pertinent Internal Revenue Code

provision and that a genuine issue of material fact existed.

The pleadings, a stipulation of facts, and answers to interrogatories and requests for admissions disclose that the taxpayer is engaged in the manufacture and marketing of ethical drugs. Prior to 1950, and over a period of more than twelve months, the taxpayer incurred expenditures which resulted in the preparation and manufacture of two pharmaceuticals with the trade names of Banthine and Dramamine. During the years here involved the taxpayer derived income from sales of these drugs. Both were developed from and arose out of research activities conducted by the taxpayer before 1950. These chemical drug compounds were not in existence prior to their being prepared through experiments with various chemical formulas. The taxpayer applied for and received patents on both products.

The taxpayer claimed that the income from the sales of Banthine and Dramamine constituted abnormal income within the meaning of Sec. 456 (a) (2) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed., Sec. 456).[1] Section 456 is designed to afford relief from

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[1] Insofar as pertinent Sec. 456 provides:

§ 456. Abnormalities in income in taxable period—

(a) Definitions.

For the purposes of this section—

(1) Abnormal income.

The term "abnormal income" means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable

the impact of excess profits taxes in certain situations which give rise to abnormally high income during the taxable year.

The taxpayer asserted that the income from the drugs Banthine and Dramamine qualified as income resulting from "discovery" within the class of income described in Sec. 456 (a) (2) (B) as:

> "Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months;"

And, alternatively, the taxpayer asserted that such income is subject to classification as abnormal income pursuant to the Treasury Regulations [2] promulgated under the provision of Sec. 456 that:

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years, the taxable years during which the taxpayer was in existence.

(2) Separate classes of income.

Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

[2] Treasury Regulations 130, Sec. 40.456-2 (b), as amended by T.D. 6026 (1953-2) Cum. Bull. 235:

(b) Other income, not within a class described in subparagraphs (A)-(D) of section 456 (a) (2), to which section 456 is

"The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary".

The District Court held that the meaning of the word "discovery" as used in the statute, did not encompass the preparation of Banthine and Dramamine because they are products arising out of research and development, and that the Treasury Regulation, to which reference has been made, is not applicable.

The common accepted meaning of the word "discovery" includes "Finding out or ascertaining something proviously unknown or unrecognized; as Curie's *discovery* of radium" (Webster's New International Dictionary (Unabridged 2d ed.) p. 745). We do not deem the maximum *noscitur a sociis* applicable. The wording of subparagraph (B) of the statute indicates that each word should be given significance independently of the others. It refers to "exploration, discovery, or prospecting, or any combination of the foregoing". The context in which the word appears suggests no reason to limit or qualify its commonly accepted meaning.

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applicable, may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456 (a) (2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456 (a) (2) (D).

That the statute herein involved omitted a provision of a similar World War II Excess Profits Tax Act which in defining abnormal income included that resulting from "research, or development of tangible property" does not in our opinion serve to narrow the scope of the word "discovery" as employed in the Internal Revenue Code provision here under consideration. The elimination of "research" and "development" as factors qualifying income for abnormal income classification served the Congressional objective of plugging "a potential loop-hole of major dimensions".[3] And, absent the element of discovery, income resulting from research or development does not by reason of the latter factors qualify for treatment as abnormal income. But the plugging of the loophole which existed under a former Act because of the use of the unqualified terms "research" and "development" does not require that the word "discovery" which the Congress saw fit to re-employ in the later enactment be regarded as having taken on the limited and qualified meaning the Government would ascribe to it. Neither the context of Sec. 456 nor the legislative history demonstrates that the term "discovery" was intended to describe only the discovery of that which is already in existence, *i.e.*, natural resources. If Congress had intended to limit the meaning of "discovery" it would have been a simple matter for it to have expressly done so.

It is our opinion that income resulting from discovery is not under the terms of subparagraph (B) of the statute precluded from classification as abnormal income merely because research or development may have occasioned, or have been factors which contributed to, the discovery. It is unnecessary to consider the argu-

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[3] H. Rep. No. 3142, 81st Cong., 2d Sess., p. 13 (1951-1 Cum. Bull. 187, 189).

ment advanced by the taxpayer concerning the application of the Treasury Regulation.

We conclude that the District Court erred in its interpretation of the statute and in granting summary judgment for the Government. A genuine issue of material fact existed as to whether Banthine and Dramamine were actually discoveries. Nothing we have said should be regarded as indicating any expression of opinion on the factual issue.

The judgment of the District Court is reversed and the cause remanded for further proceedings not inconsistent with this opinion.

REVERSED AND REMANDED.

A true Copy:
Teste:

____, ____,
*Clerk of the United States Court of Appeals for the Seventh Circuit.*

UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Chicago 10, Illinois

Wednesday, January 27, 1960

Before Hon. J. EARL MAJOR, *Circuit Judge;* Hon. ELMER J. SCHNACKENBERG, *Circuit Judge;* Hon. LATHAM CASTLE, *Circuit Judge.*

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division

No. 12747

G. D. SEARLE & CO., PLAINTIFF-APPELLANT,

*vs.*

JOHN T. JARECKI, Former Collector of Internal Revenue, and ERNEST J. SAUBER, Former Collector of Internal Revenue, etc., DEFENDANTS-APPELLEES

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, REVERSED, and that this cause be, and it is hereby REMANDED to the said District Court for further proceedings not inconsistent with the opinion of this Court filed this day.

## APPENDIX B

### UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 5622

POLAROID CORPORATION, PETITIONER,

*v.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States.

Before WOODBURY, *Chief Judge*, and HARTIGAN and ALDRICH, *Circuit Judges*.

### OPINION OF THE COURT

May 3, 1960

ALDRICH, *Circuit Judge*. This is a petition by Polaroid Corporation, hereinafter called taxpayer, to review a decision of the Tax Court holding that certain income received during the years 1951, 1952 and 1953 did not constitute "abnormal income" within the meaning of §456(a)(2), Internal Revenue Code of 1939, 64 Stat. 1186 (1951), so as to qualify for the relief provided therein from the Korean War excess profits tax.[1] The taxpayer also contests a ruling that, in computing its net abnormal income for 1951 under §456(a)(3) of the Int. Rev. Code of 1939, the interest with which it was credited in 1951 upon its successful claim for an excess profits tax refund for the years 1942 and 1943 must be reduced by the interest it was charged on income tax deficiencies which resulted from the reduced excess

[1] Excess Profits Tax Act of 1950, 64 Stat. 1137 (1951), which, with later additions, was classified as §§ 430-74, Int. Rev. Code of 1939, and is referred to hereinafter as the KW Act.

profits tax. All facts were stipulated, and the only questions are of law.

Turning to the first issue, it appears that taxpayer was incorporated in 1937. In argument before this court it described itself as "a discovery company," exclusively engaged in exploiting its own discoveries. Edwin H. Land, its President and Director of Research, is internationally known for inventions in the optical and photographic fields, perhaps the most notable of which is the Polaroid Land Camera and film, income from the manufacture and sale of which constitutes the principal matter herein involved.[2] The camera and film together (they cannot be used separately) are termed by taxpayer the Polaroid Land process. This process is unique in that it enables any user to develop his own pictures and obtain positive prints anywhere, sixty seconds after exposure. Taxpayer describes this process as a "revoluitonary discovery." We shall regard that characterization as accurate. Because of numerous patents, taxpayer has no competitors. The result has been a very substantial return of income.

Taxpayer, under Land's direction, started to develop its process in 1944. Much expenditure of time and money was required before its satisfactory achievement in 1947. Unfortunately for taxpayer, large scale production and commercial success coincided with the Korean War years, as a consequence of which income attributable in part to activities in earlier years fell within the provisions of the KW Act. The Act contains several relief provisions. Taxpayer asserts that one in particular is applicable. The Commissioner has disagreed, and the Tax Court has sustained him.

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[2] Also involved is income from sales of taxpayer's synthetic light polarizer for 3-D motion pictures. The parties agree the issues are the same, and that this matter need not be separately considered.

Under the provisions of §456 of the KW Act, income is regarded as "abnormal income," and as such is relieved from the full incidence of the excess profits provisions by reallocation to other tax years, if it falls into certain specified "classes," and meets certain additional requirements which were here concededly met. The principal issue here is whether the income falls within that class described in §456(a)(2)(B): "Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; . . . ."[3] Taxpayer asserts that the word "discovery" is broad enough to

[3] The relevant portions of § 456(a) are as follows:

"(a) Definitions. For the purposes of this section—

(1) Abnormal income. The term 'abnormal income' means income of any class described in paragraph (2) . . . if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years. . . .

(2) Separate classes of income. Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

encompass its process. The government contends that in the context of the Act it relates only to discovery of coal, oil, gas and other natural resources. It bases this in part upon internal evidence, and in part upon legislative history.

Starting with subparagraph (B), standing alone, we note that the word "discovery" admits of so many meanings that some interpretation is called for.[4] The possibility of a number of meanings for one word is a species of ambiguity. We then observe that the word is not isolated, but is sandwiched between the words "exploration" and "prospecting." The government, accordingly, invokes the doctrine of *noscitur a sociis.* In case of ambiguity this is an "appropriate and reasonable," though not always determinative test. *Russell Motor Car Co. v. United States,* 1923, 261 U.S. 514, 519. On a proper occasion "such association justifies, if it does not imperatively require," the application of a restricted meaning. *Neal* v. *Clark,* 1877, 95 U.S. 704, 709. It is particularly appropriate where one meaning of each of the grouped words has a readily apparent common denominator. Thus the words "barrel," "lock" and "stock" have each, individually, a number of quite different meanings. But if used in the phrase, "lock, stock and barrel" there could be little difficulty in determining which particular one of the several meanings was intended. The word "discovery" is clearly identified with the mining industry. See note 4, *supra.* So also are "exploration" and "prospecting." Accordingly we find a consistent, integrated

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[4] According to Webster's New International Dictionary (Second Edition, Unabridged) it includes, "1. . . . . Finding out or ascertaining something previously unknown or unrecognized; . . ." One of these meanings, which we will come to later, is "5. *Mining.* The original finding of part of a vein or lode. It is a prime requisite in the valid location of a mining claim."

unit, each portion of which casts light upon the other.[5]

Taxpayer makes no response to this (other than that set forth in the footnote), except a bare statement that the doctrine of *noscitur a sociis* is inapplicable. Its position is that since the dictionary permits it, "discovery" must be taken to comprehend inventions, or at least major "basic" inventions. If "discovery" is to have that breadth of meaning we could not accept any distinction based upon degrees of invention.[6] While we agree that basic inventions can be described as discoveries, so may any invention, no matter how minor, if it is of sufficient consequence to be entitled to a patent. Cf. United States Constitution, Art. I, §8, Cl. 8; 35 U.S.C. §§100(a), 101. If the word "discovery" is to be

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[5] Taxpayer counters by suggesting that by restricting all three words to mining there would be redundancy. That is not so. "*Discovery*" in this connection has already been defined. See note 4, *supra*. In the Encyclopedia Britannica (11th ed. 1911), in an article on Mining, is found the following: "MINING. . . . The term is not limited to [coal and ore deposits] . . . but includes . . . operations for oil, natural gas or brine. . . . *Prospecting*. . . . The work of prospecting is usually left to adventurous men. . . . The prospector is guided in his search by a knowledge of the geological conditions [etc.]. . . . *Exploratory Work*. . . . Exploratory work is associated intimately both with prospecting and with development, but the purpose is quite distinct from either prospecting, development or working, and it is of importance that this should be clearly recognized. . . ." (We quote the 11th edition of the Encyclopedia both because of its authoritative character, and because it was current when the words "exploration, discovery and prospecting" first appeared in the taxing statutes. See infra.)

[6] It seems peculiarly inappropriate that a person in taxpayer's position should be the one to attempt a distinction between original invention and subsequent minor improvements. Taxpayer possessed over a hundred patents related to the development of its process. How is one to distinguish between that part of income attributable to the original, basic invention, and that attributable to subsequent minor ones? This matter is, in a sense, moot in this case, because the parties have stipulated the amount of the tax. However, the problems it suggests are important.

taken as broad enough to include inventions, we see no reason for including some and excluding others. We are normally reluctant to adopt a construction of a taxing statute which would creat difficult administrative problems.[7] We are entirely unwilling to do so here where the act makes no suggestion of any standard.[8]

However, there is an equally serious difficulty if "discovery" is to include all processes and patented inventions. What, then, is the purpose of subparagraph (C), "Income from the sale of patents, formulae, or processes," of §456(a)(2)? See, *supra*, note 3. True, that subparagraph relates only to income from the *sale* of the patent or process. But subparagraph (B) relates to *all* income. If "discovery" in subparagraph (B) includes inventions, what is the role of subparagraph (C)? If there is a big hole in the fence for the big cat, need there be a small hole for the small one?

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[7] As will be discussed later, certain changes were made in the KW Act over its World War II (WW II) counterpart for the express purpose of avoiding such problems.

[8] In *G. D. Searle & Co.* v. *Jarecki*, 7 Cir., 1960, 274 F.2d 129, a case seemingly on all fours with this one, except that it came up on the granting of the government's motion for summary judgment of dismissal, the taxpayer claimed as abnormal income under the KW Act income from sales of certain ethical drugs. It was agreed that prior to the time taxpayer had developed and patented the formulae such compounds had never been in existence, and that they had had enormous commercial success. The court said, "The common accepted meaning of the word 'discovery' includes 'Finding out or ascertaining something previously unknown or unrecognized; as Curie's *discovery* of radium' (Webster's New International Dictionary (Unabridged 2d ed.) p. 745)." Then, cautioning that it was not "indicating any expression of opinion on the factual issue," it remanded the case to the district court to determine whether these drugs were "actually discoveries" within that definition. In view of the facts already established with relation to these drugs, we are less than clear by what tests the district court is to resolve this question, or how, in general, the Commissioner is to distinguish those patentable inventions which are discoveries from those which are not.

The existence of subparagraph (C) casts further light upon the intended meaning and scope of subparagraph (B). Suppose that instead of manufacturing under its patents, taxpayer had licensed its process to others. Would it be contended that the royalties could be claimed as abnormal income under subparagraph (B), although admittedly, should there be a sale of the process, the proceeds would fall under subparagraph (C)? Rather, it seems more reasonable to hold that Congress, having specifically provided for sales, did not intend by some more general clause to cover income of a similar nature but of less magnitude, i.e., income from a single year's use. There is an even more compelling argument. It is to be noted that §456 does not group together all sources of abnormal income, but is constructed so that the income-percentage requirements must be separately applied as to each classification or group. In determining whether, for example, abnormal income resulting from a judgment (A) is of sufficient size to qualify for relief, it is not possible to take into account abnormal income from prospecting (B). There could be no purpose to this unless each classification or group was intended to have some homogeneity within itself. This is an additional reason for applying the doctrine of *noscitur a sociis* within each group, and at the same time for differentiating one group from another. Taking the statute as a whole, we cannot accept the contention that subparagraph (B) was intended to encompass taxpayer's manufacturing income resulting from its process. On the contrary, we think it clear that "discovery" as used in that subparagraph relates to the mining industries, and to nothing else.

Ordinarily we would stop here, but since the opposite conclusion was reached in *G. D. Searle & Co.* v. *Jarecki*, 7 Cir., 1960, 274 F.2d 129, *supra* n. 8, we will deal briefly

with the legislative history to which the government has devoted its brief. This history falls into two parts; the use since 1918 of the words "exploration," "discovery," and "prospecting" in conjunction, solely with relation to the mining industry, and the particular changes effected by the KW Act over its predecessor, the World War II Act.[9] In Title III, "War-Profits and Excess-Profits Tax," of the Revenue Act of 1918, c. 18, 40 Stat. 1057 (1919), we find a limit placed on the excess profits tax that could be imposed on the proceeds from "a bona fide sale of mines, oil or gas wells, . . . where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer . . . ." Section 337, 40 Stat. 1096. An identical provision in the income tax portion of the statute, §211(b), 40 Stat. 1064, limited the surtax upon such income in the case of individual taxpayers. Congressional history discloses that these provisions were designed to encourage the search for oil and ore deposits during wartime, and to offset the unfairness of taxing in a single year income which was possibly the result of many unprofitable years of prior search. See S. Rep. No. 617, 65th Cong., 3d Sess. 6 (1918). (1939—1 Cum. Bull. (Part 2) 117, 129-21). They were repeated in the income tax and the excess profits tax titles of the Revenue Act of 1921, c. 136, §§211(b), 337, 42 Stat. 237, 277. There was no further excess profits taxation until 1940, but these words continued to appear in the income tax statutes, with one exception,[10] until excess profits tax imposition returned

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[9] Excess Profits Tax Act of 1940, c. 757, 54 Stat. 975, which, together with later additions and amendments, was classified as §§710-84, Int. Rev. Code of 1939, and is hereinafter referred to as the WW II Act.

[10] The single exception is the Revenue Act of 1934, c. 277, 48 Stat. 680. When the provision was revived in the Revenue Act of 1936,

with World War II. By that time, in the light of this repeated and almost continuous application to the mining industry (and no other), we think that these words had become well-recognized words of art.

The World War II excess profits tax act exhibits a major schematic change from the earlier acts, but again we find the words "exploration," "prospecting," and "discovery" used together in a relief provision. The here relevant portion (noticeably similar, as will be seen, to §456 of the KW Act) was §721(a)(2)(C):[11] "Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; . . . ." Discussion on the floor of Congress indicates that the mining industry was intended as one of the primary beneficiaries of this relief. See, e.g., 86 Cong. Rec. 12174-77, 12350, 12919 (1940); 87 Cong. Rec. 1636 (1941). With the Korean War enactment, subparagraph (C) of §721(a)(2) was split in two. It is interesting to note the form of this division. The words "exploration, discovery, prospecting" were taken as one group, and placed in subparagraph (B) of the new law, while "patents, formulae, or processes" were placed together in subparagraph (C), and at the same time the words "research, or development of tangible property" were dropped. These changes "re-

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c. 690, § 105, 49 Stat. 1678, the phrase in question was changed to "prospecting or exploration or [instead of "and"] discovery work," and the section as a whole was limited to oil or gas property. In this form it was carried into the Internal Revenue Code of 1939, c. 2, § 105, 53 Stat. 36 (now § 632 of the Int. Rev. Code of 1954).

[11] Excess Profits Tax Act of 1940, c. 757, § 201, 54 Stat. 986, as amended, Excess Profits Tax Amendments of 1941, c. 10, § 5, 55 Stat. 21. Subparagraph (C) of the amended act was derived from, and is practically identical to, subsection (c) of the original § 721.

defined and restricted" the types of income to which this special treatment was to be afforded. H.R. Rep. No. 3142, 81st Cong., 2d Sess. 63 (1950) (1951—1 Cum. Bull. 187, 231). The House and Senate reports described the excised portion as a "potential loophole of major dimensions," and stated that it was being omitted "because there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (section 722), and because the need for a reallocation of such income seemed to be materially less than in the other classes of income described . . . ." *Id.* at 13 (1951—1 Cum. Bull. at 195); S. Rep. No. 2679, 81st Cong., 2d Sess. 14 (1950) (1951—1 Cum. Bull. 240, 249). Thus even "meritorious cases" that would have come under this now excluded phrase were deliberately sacrificed in the interest of administrative simplification.[12]

In the face of this history, it would be difficult for us to feel that there was introduced into the newly created subparagraph (B) with the word "discovery" a scope of meaning which would include manufacturer's profits from inventions, whether those inventions were revolutionary, or otherwise. Taken in conjunction with internal evidence within the statute itself, we find it impossible.

We turn next to taxpayer's contention, that even if it is not entitled to classify the income in question as "dis-

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[12] In this connection it is to be noted that it was stipulated that taxpayer's income from its process was "income from the sales of tangible property arising out of research and development which extended over a period of more than 12 months." Thus taxpayer must contend that it remained within the purview of this statute after the words which were the most applicable to it were removed.

covery" income under §456(a) (2) (B), it is nonetheless entitled to relief under the last sentence of subsection (a) (2). This reads, "The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary." Note 3, *supra*. The relevant regulations are set forth below.[13] We agree with taxpayer that this sentence may be taken as giving the Secretary the authority to accept classifications outside of the express provisions of subparagraphs (A)-(D). But the language is permissive, and we have found nothing in the historical background indicating that the Secretary's role in agreeing to additional classifications was to be one of obligation rather than of discretion. We therefore reject any contention that the Secretary, or Commissioner, was required to grant relief on the basis of a classification suggested by a taxpayer merely because the taxpayer has income which meets the other tests of abnormality. Nor do the regulations themselves assist the taxpayer. First, any classification by a tax-

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[13] Treas. Regs. 130, § 40.456-2(b) (1951), as amended, T.D. 6026, 1953—2 Cum. Bull. 235: "Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)."

payer is "subject to approval by the Commissioner," and such approval was not given here. Secondly, under this regulation the classification must be "similar to those specified in subparagraphs (A)-(D) . . . ." If "discovery" relates to mining and natural resources, taxpayer's classification is not "similar." It may be similar (if in fact it is not completely described by the phrase) to "research or development," but the regulations, in accord with the legislative history already discussed, specifically state that income of this class is not subject to relief. The last sentence of the regulations, on which taxpayer places great emphasis, furnishes it no support. That sentence merely provides that income otherwise properly includible within a class is not to be excluded merely because it happens to constitute income from research and development. However, we are unable to find, either in the statute or in the regulations, any class in which to place taxpayer's income other than a classification which is specifically excluded.

One matter remains. Taxpayer, prior to the instant case, pursued a claim for relief under §722 of the WW II Act for overassessments of excess profits taxes for the years 1942 and 1943. In 1951 it was successful. In connection with the settlement it was credited with interest. The government agrees that this interest was abnormal income in 1951. Section 456(a)(2)(A). However, under the WW II Act, the reduction of taxpayer's excess profits income correspondingly increased its normal-tax income, resulting in a deficiency for those years, and an interest charge thereon. The Commissioner held, and was sustained by the Tax Court, that in computing 1951 net abnormal income this interest charge should be subtracted from the abnormal income (i.e., the interest credit) as one of the "costs or deductions relating to such abnormal income, allowable

in determining the normal-tax net income for the taxable year . . . ." [14]

It is true that the interest charge was a result of, and therefore attributable to, the overassessment to which the interest credit was also attributable. Therefore, in a broad sense, they were "related." It is also true that this charge would, in the general compass of the word, constitute a "deduction" "allowable in determining the normal-tax net income." Int. Rev. Code of 1939, §23(b). There is one little cloud. What is the word "costs" doing there? Having in mind the broad meaning that might be given to "deductions" standing alone (as, indeed, including costs), does the presence of the word "costs" suggest that "deductions relating" was intended to mean something relating in the same manner as costs? In H.R. Rep. No. 3142, 81st Cong., 2d Sess. 63 (1951—1 Cum. Bull. 187, 231), it is stated that the clause here in question was intended principally as a "clarification of the technical provisions" of §721 (a) (3) of the WW II Act. Examination of this earlier statute [15] discloses that whatever clarity it may have lacked in other respects, it was entirely clear with re-

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[14] "(3) Net abnormal income. The term 'net abnormal income' means the amount of the abnormal income less, under regulations prescribed by the Secretary, (A) 115 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any costs or deductions relating to such abnormal income, allowable in determining the normal-tax net income for the taxable year, as the excess of the amount of such abnormal income over 115 per centum of such average amount bears to the amount of such abnormal income." Section 456(a)(3).

[15] The corresponding portion of § 721(a)(3) reads as follows: ". . . direct costs or expenses, deductible in determining the normal-tax net income of the taxable year, through the expenditure of which such abnormal income was in whole or in part derived . . ."

gard to the present question. There the phrase corresponding to "deductions relating" ("to such abnormal income") was "expenses, . . . through the expenditure of which" ("such abnormal income was in whole or in part derived"). This was a limited, causative relationship, entirely compatible with the word "costs," and falling far short of the meaning contended for here by the government. It is true that we are to apply §456(a)(3) and not §721(a)(3). On the other hand, by reading §456(a)(3) in the manner contended by the government we find an awkwardness in, and apparent absence of purpose for, the presence of the word "costs," while we find none if this statute is construed to read like its predecessor. In view of the legislative history, we will adopt that construction.[16]

It may be that from an "equitable" standpoint it would be appropriate for taxpayer's interest out to be offset against its interest in. But as the government was quick to assert when the shoe was on the other foot, we are applying tax statutes, not principles of equity. *See Babcock & Wilcox Co.* v. *Pedrick*, 2 Cir., 1954, 212 F.2d 645, *cert. den.*, 1955, 348 U.S. 936. This ruling of the Tax Court must be set aside.

*Judgment will enter vacating the decision of the Tax Court, and remanding the case for further proceedings in accordance with this opinion.*

[16] For what it may be worth, we note that the example given by the Regulations (Treas. Regs. 130, § 40.456-1(e) (1951)) with respect to this clause hypothesizes "deductible expenses," not just "deductions."

## APPENDIX C

Internal Revenue Code of 1939:

SEC. 456. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) *Definitions.*—For the purposes of this section—

(1) *Abnormal income.*—The term "abnormal income" means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

* * * * *

SEC. 721 [as amended by Section 5 of the Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17, and Section 221(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) *Definitions.*—For the purposes of this section—

(1) *Abnormal income.*—The term "abnormal income" means income of any class includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income constituting an amount payable under a contract the performance of which required more than 12 months; or

(C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting; or

(E) In the case of a lessor of real property, income included in gross income for the taxable year by reason of the termination of the lease; or

(F) Income consisting of dividends on stock of foreign corporations, except foreign personal holding companies.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.

* * * * *

Treasury Regulations 130, promulgated under the Internal Revenue Code of 1939:

SEC. 40.456-2 [As amended by T.D. 6026, 1953-2 Cum. Bull. 235]. *Classification of Income.*—

(a) Section 456(a)(2) (A), (B), (C), and (D) sets forth four separate classes of income. All the

income which reasonably is classifiable in more than one class shall be classified under the one which the taxpayer irrevocably elects. Such election shall be made in the manner prescribed in section 40.456-3. The classification of income for any year must be consistent with the classification made under section 456 for previous years. The classification must also be consistent with any classification made in applying section 433(b)(9) to the taxpayer.

(b) Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D).

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No. 151

IN THE

# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1960

JOHN T. JARECKI, former Collector of Internal Revenue, et al.,

*Petitioners,*

*vs.*

G. D. SEARLE & CO.,

*Respondent.*

**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## BRIEF FOR THE RESPONDENT IN OPPOSITION

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**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

---

## BRIEF FOR THE RESPONDENT IN OPPOSITION

---

### Opinions Below

The opinion of the court of appeals is reported in 274 F. 2d 129. The district court's findings of fact, conclusions of law, and summary judgment (R. 43-48)[1] are not officially reported.

### Jurisdiction

The judgment of the court of appeals was entered on January 27, 1960 (Pet. 14). The petition for a writ of cer-

1. Record references are to the Appendix to respondent's brief in the court of appeals.

tiorari was filed on June 16, 1960. The time within which to file this brief in opposition was extended to and including September 1, 1960. The jurisdiction of this Court has been invoked under Section 1254 of the Judicial Code.

## Question Presented

Is respondent entitled to a trial on the merits of its suit for refund of excess profits tax under the provisions of Section 456 of the Korean War Excess Profits Tax Law, granting relief for certain statutory classes of income designated as abnormal income? Respondent asserts that income resulting from its discovery of two break-through drugs affecting completely new treatments for illness qualifies for relief under this statute.

## Statute and Regulation Involved

Section 456 of the Excess Profits Tax Act of 1950, which is no longer in effect (see 67 Stat. 175), provided in pertinent part (64 Stat. 1137, 1186; Section 456 of the Internal Revenue Code of 1939, 26 U.S.C. 1952 ed., § 456):

"SEC. 456. *Abnormalities in income in taxable period.*

"(a) *Definitions.*—For the purposes of this section—

"(1) *Abnormal income.*—The term 'abnormal income' means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

"(2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

"(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

"(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

"(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

"(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

* * * * *

Section 40.456-2(b) of Treasury Regulations 130 (as amended by Treasury Decision 6026 of July 3, 1953) provides as follows:

"Other income, not within a class described in subparagraphs (A)-(D) of section 456 (a) (2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456 (a) (2) as are reasonable in a business of the type which the taxpayer conducts, and as are

appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456 (a) (2) (D)."

## Statement

Contrary to the opening sentence of the statement in the petition for certiorari, the facts are in dispute. Many crucial facts are disputed (p. 5 of March 31, 1959, transcript; see R. 53). However, certain other facts are established by the record. Respondent G. D. Searle & Co., a pharmaceutical company, seeks to recover part of the excess profits taxes paid for the years 1950 through 1952 on income resulting from its discovery of two drugs, Banthine and Dramamine (R. 3-17). Summary judgment was entered against respondent (R. 48) despite its insistence that factual issues are involved and evidence required to support its claim.

This proceeding involves respondent's right to tax relief under the Korean War Excess Profits Tax Act for income resulting from discovery of two drugs, Banthine and Dramamine. This Act permits special treatment of income resulting from discovery if the income falls within a class of "abnormal income" specified by the Act. If part of such "abnormal income" is attributable to other years, the statute allows mitigation in some degree of the full excess profits tax impact.

One of the district court's orders in this proceeding limited the substantive issue to the determination of the character or class of respondent's income from these discoveries. Other issues raised by the requirements of the Act, such as the computation of the amount of abnormal income and the years of attribution, have all been held in abeyance. (R. 27-28.)

Respondent appealed from a summary judgment rendered for petitioners by the district court (R. 48). The district court held that respondent's drugs were "products arising out of research and development and as such specifically prohibited by Congress from being considered discoveries within the meaning of Section 456(a)(2)(B)" (R. 46). Respondent also contended in the alternative that even if its income from the discoveries of Dramamine and Banthine was not the result of "discovery" within the meaning of Section 456(a)(2)(B), it constituted a separate class of abnormal income granted relief under the last sentence of Section 456(a)(2) (R. 45). The district court held, however, that "income from the sale of tangible property arising out of research and development may not be classified as abnormal" under any theory (R. 47).

Since this case arose on appeal from a summary judgment, the record contains few of the facts which respondent intended to establish at the trial. Dramamine is a new drug for the relief of motion sickness and Banthine a new drug for the treatment of peptic ulcers. Respondent advised the district court of its intent to prove that both Dramamine and Banthine were break-through discoveries involving new compositions of matter, and that their effect on the body constituted an unprecedented approach to the treatment of motion sickness and peptic ulcers (see Transcripts of both district court hearings, R. 53). Contemporary medical lit-

erature and other publications termed these two drugs *discoveries*, for, unlike all of respondent's other products, they were not improvements on existing drugs (cf. R. 3, 31-40). Their large sales and widespread imitations were further indicia that these drugs were genuine discoveries.

In the alternative, respondent intended to prove at the trial that it was "reasonable" and "appropriate" within the meaning of the applicable Treasury Regulations to treat the income from Dramamine and Banthine as abnormal under the last sentence of Section 456(a)(2) even if it did not qualify as "discovery" income under Section 456(a)(2)(B), since these drugs were utterly dissimilar from any of respondent's other products (see R. 3-4).

Respondent's income and excess profits tax payments during the three years in question totaled $19,093,230.47 (R. 19, 20). Of this amount, the complaint sought to recover approximately $3,600,000 under the abnormal income provisions of the Korean War Excess Profits Tax Act (R. 44).

Concluding that factual issues were presented, the court of appeals reversed the summary judgment and held that respondent should be permitted to prove whether Dramamine and Banthine are actually discoveries (Pet. 13). The judgment of the court of appeals did not determine that respondent is entitled to recover any particular amount: only that respondent be given an opportunity to prove its case. The judgment leaves to the trial court all questions of determination of existence of abnormal income, including the complicated statutory computation of amount (see R. 5-6, 27-28).

## ARGUMENT

Correctly holding that summary judgment was improper until the facts could be developed, the court of appeals has remanded this case for trial. Thus the issues are not ripe for adjudication here nor is a true conflict of decisions presented. Moreover, the statute involved expired in 1953, so that the question presented is of insufficient importance to warrant review by this Court.

1. No final judgment has been rendered. The court below has not decided that respondent is entitled to any recovery. The court felt that all the facts should be developed before a final ruling is made and that it would certainly be wrong to decide novel questions of law in a vacuum. Cf. *American Securit Co.* v. *Hamilton Glass Co.*, 254 F. 2d 889, 892, 893 (C.A. 7, 1958). Its holding is only that respondent should not be prevented by summary judgment from proving that Dramamine and Banthine are "discoveries" within the relief provisions of Section 456(a)(2) of the Korean War Excess Profits Tax Act (*supra*, p. 3). A litigant's opportunity to prove essential facts must not be cut off by summary judgment. *Sartor* v. *Arkansas Natural Gas Corp.*, 321 U. S. 620, 627; *Fountain* v. *Filson*, 336 U. S. 681; *United States* v. *Western Pacific R. Co.*, 352 U. S. 59, 75-76. Here the essential facts are sharply controverted.[2] Because of the summary judgment which respondent strenuously opposed, respondent had no opportunity to show that both these products were break-through discoveries, involving new compositions of matter not in existence before respondent discovered them (R. 30, 41, 44), and that each affected

2. Petitioners themselves so asserted, when they advised the district court that "we [the parties] disagree as to the facts" (p. 5 of March 31, 1959 transcript; see R. 53). The right of either party to introduce evidence at the trial was preserved (R. 26) because petitioners finally proved unwilling to stipulate as to facts that respondent considered essential.

the human body in an unprecedented way in relieving motion sickness and peptic ulcers. Respondent was also foreclosed from proving in the alternative that it was "reasonable" and "appropriate" under the applicable Treasury Regulation (*supra*, pp. 3-4) to treat the income from these two drugs as abnormal under the last sentence of Section 456(a)(2) of the Act (see R. 3-4).

As in both courts below, petitioners' principal contention is that neither Dramamine nor Banthine income can qualify for relief since both products resulted from research and development (Pet. 3, 4-5; R. 43, 45). Petitioners' contention that all income arising from research and development is excluded from relief under Section 456 is untenable. In July 1953 the Treasury refused to promulgate a proposed regulation to that effect (17 F. R. 10973) and instead issued the present regulation which states positively that Section 456 is applicable to income from research and development if the income fits into one of the classes to which Section 456 applies.[3] Concededly, discovery income is one of such classes. If petitioners were correct that no research or development income can come within Section 456, discovery income could not qualify for relief even though Section 456(a)(2)(B) expressly accords relief to such income! Petitioner's statement that the Seventh Circuit regarded "discovery" as "broad enough to include anything which is the result of research and development" (Pet. 4) is inaccurate. The opinion of the court of appeals clearly recognized that "absent the element of discovery, income resulting from research or development does not by reason of the latter factors qualify for treatment as abnormal income" (Pet. 12). The decision below merely held that

3. See Section 40.456-2(b) of Treasury Regulations 130, as amended by Treasury Decision 6026 of July 3, 1953 (1953-2 Cum. Bull. 235), *supra*, pp. 3-4.

"income resulting from discovery is not under the terms of subparagraph (B) of [Section 456(a)(2) of] the statute precluded from classification as abnormal income merely because research and development may have occasioned, or have been factors which contributed to, the discovery" (Pet. 12).

Although the common and statutory use of "discovery" has not been confined to the mining industry,[4] petitioners also contend that "discovery" in Section 456 means only discovery of natural resources through mining (Pet. 5). Congress did not so specify, nor does the legislative history support petitioners. Actually in the 1940 predecessor statute, "discovery" occurred in the phrase:

> "Income resulting from exploration,[5] discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, *or any combination of the foregoing* * * *" (54 Stat. 974, 986; 55 Stat. 17, 22; Section 721 of the Internal Revenue Code of 1939, 26 U.S.C. 1952 ed., § 721; italics supplied).

According to their genesis, the associated words thus unequivocally show Congress was not limiting relief to mining operations under the 1940 statute (see, *e.g.*, *W. B. Knight Machinery Co.*, 6 T.C. 519 (1946); *Rochester Button Co.*, 7

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4. See, *e.g.*, Sections 151-155, 157-158 of the Atomic Energy Act (42 USC §§ 2181-2185, 2187-2188); Section 517(a)(1) of the Mutual Security Act (22 USC § 1668(a)(1)); and Section 5(i) of the Tennessee Valley Authority Act (16 USC § 831d(i)).

5 The term "exploration" is not confined to a narrow geophysical meaning. Thus in I Oxford English Dictionary (1933 ed.), exploration is defined as follows (p. 657):

> "1. The action of examining; scrutiny—1655. 2. *Med.*, etc. The examination of an organ, a wound, etc. by the use of the finger, a probe, or the like 1860. 3. The action of exploring; an instance of this 1823."

In Webster's New International Dictionary (Unabridged 2d ed.) "explore" is defined as follows (at p. 898):

> "1. To seek for or after; to strive to attain by search."

T.C. 529 (1946)), and Congress gave no indication in 1950 that it suddenly intended to confine relief to the mining industry. Furthermore, *noscitur a sociis* may not be employed to limit the plain meaning of a word. *Russell Co.* v. *United States*, 261 U. S. 514, 519-520; *Wong Kam Wo* v. *Dulles*, 236 F. 2d 622, 626-627 (C.A. 9, 1956); 2 Sutherland, Statutory Construction (3d ed.) § 4908 at pp. 393-394. The plain meaning of discovery would include rare pioneer or break-through drugs such as these. For example, Webster's definition of discovery includes "(a) Finding out or ascertaining something previously unknown or unrecognized; as Curie's *discovery* of radium" (Webster's New International Dictionary (Unabridged 2d ed.) p. 745). In fact, when Congress was considering the instant statute, certain drugs which were also responsible for radical changes in the field of medicine were described by a witness at the hearings in terms of "discoveries":

> "The discovery or development of another aureomycin or another ACTH or of a cure for cancer during the taxable year must be encouraged and not penalized" (Hearings before the Senate Finance Committee on H.R. 9827, 81st Cong., 2d Sess. (1950), p. 709).

Entirely new chemical compounds of medical value were deemed to be discoveries in *Smith, Kline & French Laboratories* v. *Clark & Clark*, 157 F. 2d 725, 729 (C.A. 3, 1946), certiorari denied, 329 U. S. 796, and *Wisconsin Alumni Research Foundation* v. *George A. Breon & Co.*, 85 F. 2d 166, 167, 171, 172 (C.A. 8, 1936). The Treasury Department has also concluded that drugs can qualify as discoveries within Section 456(a)(2)(B), for it recently settled a claim involving a popular antibiotic, a product of one of respondent's competitors. In the present case the examining officer of the Internal Revenue Service concluded that at least Dramamine was a discovery within the ordinary meaning of the

word (R. 31, 54). In the absence of clear indications of contrary intent, "words used in legislative enactments • • • are to be given their known and ordinary signification" rather than a limited or special meaning. *United States Gypsum Co.* v. *United States*, 253 F. 2d 738, 744 (C.A. 7, 1958), acq. Rev. Rul. 58-593; see also *Commissioner* v. *Marshall's Estate*, 203 F. 2d 534, 537 (C.A. 3, 1953); *United States* v. *Merchants National Bank*, 261 F. 2d 570, 575 (C.A. 5, 1958).

There is no reason for believing that Congress wished to give a limited, special meaning to the term discovery and thereby eliminate income from such pioneer or breakthrough discoveries as Dramamine and Banthine from the class of income which, under Section 456(a)(2)(B), was entitled to certain mitigation of the excess profits tax. On the contrary, an examination of the policy behind Section 456 adds further force to the argument that respondent's discoveries fall within the terms of the law. The main objective of the excess profits tax was to tax profits attributable to the large military budget and a profitable wartime economy. As the House Report stated:

> "One of the main objectives in imposing an excess profits tax is to reach corporate profits which have been swollen by the increased tempo of the economy. An excess profits tax selects for additional tax those corporations whose profits are higher than they probably would have been in the absence of hostilities and a large military budget." (H.R. Rep. No. 3142, 81st Cong., 2d Sess. (1950) (1951-1 Cum. Bull. at p. 187)).

In providing relief in exceptional situations such as those indicated by Section 456(a)(2), Congress recognized that in some instances high profits would not be attributable to military spending and the generally higher wartime econ-

omy. Section 456 should be construed to take this into account, as was its World War II predecessor:

> "Congress anticipated that business for many taxpayers would improve because of external changes and it intended the tax to apply in those cases. It also realized that there might be some instances in which the income of the base period years might not satisfactorily reflect internal changes in the business. That is, there might be cases in which the increase in profits of the tax year over those of the base years might be attributed, at least in part, to internal changes and development of a particular business or some phase of that business to its full stature and to that extent would not be attributable to the outside business stimulus." *Soabar Company*, 7 T.C. 89, 96 (1946).

Unless the income from respondent's discoveries falls within the abnormal income relief provisions of Section 456(a)(2), the coincidence that the discovery of Dramamine and Banthine occurred shortly before the outbreak of the Korean War would operate to penalize respondent in a way which Congress did not intend. These drugs had nothing to do with the war. Respondent's discoveries, because they were new and useful advances in medicine, would have resulted in abnormal income to the discoverer in peacetime as well. This income was the result of "internal changes and development of a particular business" (7 T. C. at p. 96); it was not a case of income "swollen by the increased tempo of the economy" as a whole (1951-1 Cum. Bull. at p. 187). Actually the volume of sales increased dramatically after hostilites had ceased (see R. 23).

Moreover, the discovery of these drugs, like most other discoveries of new products, resulted from years of effort and expense which were brought to fruition during the excess profits tax period (see R. 3, 4, 6). The competitive advantage of a new discovery lasts only a short time.

Recognizing the unfairness of bunching for heavy taxation in one year discovery income which is in fact attributable to several years, Congress intended that such abnormal income from discovery, if it can be shown to be attributable to other years, should be taxed accordingly. All respondent seeks is an opportunity to prove that its income in question was in fact attributable to other years and therefore entitled to relief. Certainly Congress was aware of the common meaning of the word "discovery", and if it had felt that "discovery" of minerals, etc. was more deserving of relief legislation than a "discovery" of vital importance to the health of millions of individuals, it would have so stated. See *Commissioner* v. *Quartzite Stone Co.*, 273 F. 2d 738, 739 (C.A. 10, 1959), certiorari not authorized, 1960 P-H Fed. Taxes ¶ 56,370.

2. The alleged conflict of decisions does not exist. Here the ruling of the court of appeals will merely grant respondent its day in court and permit evidence as to whether or not Dramamine and Banthine are discoveries within Section 456. Further, the court of appeals found it unnecessary, and expressly declined, to pass upon respondent's alternative contention that respondent be allowed to show that its income should be placed in a separate similar class permitted by the last sentence of Section 456 and the Treasury Regulation issued thereunder. *Polaroid Corporation* v. *Commissioner*, 278 F. 2d 148 (C.A. 1, 1960), presents no conflict because there the taxpayer had the trial to which it was entitled, with fully developed facts presented to the trial court. Then too *Polaroid* concerned an improved camera and film, whereas here involved are new compositions of matter not in existence before respondent discovered them (R. 3, 30, 41, 44) and operating in unprecedented ways on the human body (R. 3). There is no similarity whatever between improvements of camera and film designed for photographing humanity and break-through discoveries of remedies which provide great relief for human suffering.

## CONCLUSION

This case does not involve any principle of general importance and the governing statute expired in 1953. The decision below properly held that taxpayer should not be prevented by summary judgment from developing essential factual issues at trial. No true conflict of decisions is presented. Accordingly, a writ of certiorari should not issue.

Respectfully submitted,

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August 1960.

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No. 151

# In the Supreme Court of the United States

OCTOBER TERM, 1960

JOHN T. JARECKI,
FORMER COLLECTOR OF INTERNAL REVENUE, ET AL.,
PETITIONERS

*v.*

G. D. SEARLE & CO.

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

## BRIEF FOR PETITIONERS

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| II. The legislative history establishes that, in including income resulting from "exploration, discovery, or prospecting" among the classes of "abnormal income" accorded special treatment under Section 456, Congress used those terms in the same sense in which they have been employed consistently in internal revenue taxation, including excess profits taxation, since 1918—*i.e.*, with reference only to the oil, gas, and other natural resources industries | 18 |




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# In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 151

JOHN T. JARECKI,
FORMER COLLECTOR OF INTERNAL REVENUE, ET AL.,
PETITIONERS

*v.*

G. D. SEARLE & CO.

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

## BRIEF FOR PETITIONERS

### OPINIONS BELOW

The opinion of the District Court (R. 41–45) is not officially reported. The opinion of the Court of Appeals (R. 49–53) is reported at 274 F. 2d 129.

### JURISDICTION

The judgment of the Court of Appeals was entered on January 27, 1960. (R. 54.) On April 22, 1960, by order of Mr. Justice Clark, the time within which to file a petition for a writ of certiorari was extended to and including June 25, 1960. (R. 56.) The petition was filed on June 16, 1960, and granted on October 10, 1960, 364 U.S. 812. (R. 57.) The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

## QUESTION PRESENTED

Whether the income received by the taxpayer from the sale of certain patented drugs resulted from "discovery", within the meaning of Section 456(a)(2)(B) of the Internal Revenue Code of 1939, so as to qualify for Korean War excess profits tax relief as "abnormal income".

## STATUTES, REGULATIONS AND RULINGS INVOLVED

Section 456 of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 24a–29a) and other pertinent statutory and regulatory provisions are set forth in the Appendix, *infra*, pp. 1a–24a, 29a–52a.

## STATEMENT

This action was instituted by the taxpayer (R. 3–15) to recover excess profits taxes aggregating $3,638,238.82 (plus interest) alleged to have been erroneously and illegally assessed and collected by the petitioners for the years 1950, 1951 and 1952. The material facts, as set forth in the District Court's findings (R. 41–43) and in the opinion of the Court of Appeals (R. 50), may be summarized as follows:[1]

The taxpayer, a Delaware corporation with its principal place of business in Skokie, Illinois, is engaged in the business of manufacturing and marketing "ethical drugs". Prior to 1950, and over a period of more than twelve months, the taxpayer incurred expenditures which resulted in the preparation and

[1] These facts are undisputed, having been developed entirely by admissions in the pleadings (R. 3–18), by a stipulation of facts (R. 24–25), and by answers (R. 21, 22–23, 39, 40) to interrogatories (R. 19, 20) and to requests for admissions (R. 26–28, 29–38).

manufacture of two pharmaceuticals, with the trade names of "Banthine" and "Dramamine". During the taxable years involved, the taxpayer derived income from the sale of those two drugs. (R. 41–42.) [2]

Both Banthine and Dramamine were developed as a result of research activities conducted by the taxpayer prior to 1950.[3] (R. 42.) Both are chemical drug compounds, which were unknown prior to their being prepared by the taxpayer through experiments with various chemical formulae. (R. 42; see also R. 27, 39.) The taxpayer applied for a product patent on Dramamine in March 1940 (granted in February of 1950) and on Banthine in May 1952 (granted in November of 1953). (R. 42.) [4]

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[2] That income—which is the subject of the present controversy—amounted to, for the years 1950, 1951 and 1952, respectively, $3,328,606, $9,347,180 and $8,348,212 as to Banthine, and $2,044,797, $2,484,406 and $3,324,933 as to Dramamine. (R. 21.)

[3] The nature of pharmaceutical research involved is described in some detail in Exhibit C (unprinted) to the Government's Request for Admissions. (R. 26.)

The extent of the taxpayer's research and development program is also shown by the record in considerable detail—including specific figures as to the amounts (obviously constantly increasing) of expenditures, personnel, and facilities devoted by the taxpayer to its research activities. (R. 22–23.) See also the Exhibits (unprinted) to the Government's Request for Admissions (R. 26)—particularly, Exhibit A, pp. 10–13, "Change in Products and Services Furnished;" Exhibit B, Prospectus (1950), p. 7, "Research;" Exhibit D, Annual Report (1950), pp. 14–15, "Expansion of Research Personnel and Equipment;" Exhibit E, Annual Report (1951), pp. 14–15, "New Personnel and Facilities of Research during 1951," p. 20, "1951 Developments in the Products of Searle Research.")

[4] The taxpayer had also been granted a product patent in 1941 on a drug called Pavatrine (R. 42), from the sale of which it derived income in amounts ranging from some five hundred dollars in 1942 to in excess of a million dollars in 1949 and in 1950

In this action, the taxpayer sought to recover excess profits taxes for the years in question, upon the theory that its income from the sales of Banthine and Dramamine during the period 1950 through 1952 constituted "abnormal income" within the meaning of Section 456(a)(2) of the Internal Revenue Code of 1939. (R. 41–43, 49–52.) Upon the Government's motion for summary judgment (R. 40–41), the District Court dismissed the complaint (R. 45). It held that the taxpayer's income from sales of Banthine and Dramamine was not income resulting from "exploration, discovery, or prospecting" within the meaning of Section 456(a)(2)(B), but income from the sale of products arising out of research and development. The District Court further held that the taxpayer's income from the sale of the drugs in question may not be classified as "abnormal" under the Regulations (Section 40.456–2(b) of Treasury Regulations 130) promulgated pursuant to the last sentence of Section 456(a)(2). (R. 44.)

The Court of Appeals held, however, that the income in question could qualify for relief as income from "discovery" under Section 456(a)(2)(B).[5] Accordingly, it reversed and remanded the case for trial, stating that a "genuine issue of material fact existed

(R. 21). The income from this drug is not involved in the present controversy.

The taxpayer had also applied for patents on two other drugs, Tetrathione and Hydryllin, which were denied (or abandoned) in 1948 and 1952, respectively (R. 42), but neither of those drugs is involved in this controversy.

[5] In view of its construction of Section 456(a)(2)(B), the Court of Appeals found it unnecessary to consider the District Court's interpretation of the applicable Regulations. (R. 53.)

as to whether Banthine and Dramamine were actually discoveries". (R. 53.)[6]

INTRODUCTION AND SUMMARY

The Korean War excess profits tax law, like its World War II predecessor, makes provisions in various ways for treating certain classes of income as "abnormal income." Such "abnormal income" is relieved from the full incidence of excess profits taxation by reallocation to other tax years. The statutory issue presented by this case is whether taxpayer's income from the sale of two of its drugs can qualify for relief under Section 456(a)(2)(B), which relates to income from "exploration, discovery, or prospecting."

Taxpayer's position is bottomed on the proposition that the word "discovery", in one of its dictionary meanings, is broad enough to cover either an invention or a new product which is the outgrowth of research and development. We do not deny that "discovery" is a word of various meanings, some of broad connotation. We point out, however, that in one of its most familiar usages it relates to the finding of natural resources. In our view, it is in this sense that the term is used in the statute.

For this view (which has been adopted by the First Circuit in the companion *Polaroid* case), Section 456(a)(2)(B) provides its own intrinsic evidence. "Discovery" does not appear in isolation.

[6] Subsequently, on April 22, 1960, the Government filed a motion with the Court of Appeals for leave to file a petition for rehearing out of time, for the purpose of presenting more extensive legislative history of the Code section here involved and its antecedents. That motion was denied on April 28, 1960. (R. 55.)

The statutory phrase is "exploration, discovery, or prospecting." Each of the three nouns employed relates to a distinct phase of activity in the natural resources industries. Since it is this relationship to natural resources which provides their common denominator, the interpretation which we urge is, on the face of it, the most plausible one. It is also the interpretation which has been adopted in Treasury Regulations.

There are other considerations which point most persuasively to the same conclusion.

There is, first, the consideration that other provisions in the Korean War law provide relief in appropriate cases in relation to new products, growth or expansion in commercial activity.

Even more pointedly, Congress rejected an earlier provision of the World War II law which had explicitly granted relief to income resulting from "research, or development of tangible property, patents, formulae, or processes," while concurrently retaining a provision authorizing relief in respect of income from the *sale* of patents, formulae or processes. The reason assigned for the elimination of the provision governing "research and development" income seems conclusive against the taxpayer's position; both the relevant Senate and House reports described the excised portion as "a potential loophole of major dimensions" and stated that there appeared to be "no means of restricting" such an adjustment to "truly meritorious cases" without delegating to administrative authorities a breadth of discretion which Congress regarded as undesirable. Congress was appar-

ently of the view that no comparable breadth of discretion was necessary in order to enable the Commissioner to identify income from specific mineral deposits or from patents, formulae or processes which already had been the subject of a sale.

A further factor which bears importantly upon the issue of statutory interpretation is that the words "exploration", "discovery" and "prospecting" have been used repeatedly in income and excess profits tax statutes since 1918 (*e.g.*, in connection with mineral depletion and sale of minerals property) and that they have been used without exception to refer to the natural resources industries, for which Congress has frequently provided—in various ways and for various reasons—special tax treatment. Indeed, it was those industries which sponsored Section 456(a)(2)(B).

Finally, a study of the successive excess profits tax statutes and of their evolution serves to emphasize that Congress had gradually turned from relief provisions which vest broad and virtually unfettered discretion in the Commissioner and has substituted provisions which, in its view, permit computations to be made with reasonable accuracy and certitude and in terms of settled tax concepts. To develop this point we have undertaken to explain at considerable length the operation of the various excess profits tax statutes (and, also, of related income tax provisions) beginning with the laws enacted during World War I. This history shows, we believe, that it would be inconsistent with the scheme of the law as it emerged during the Korean War to interpret Section 456 as covering income, of a manufacturer from sales of a

new product resulting from research or development. Such an interpretation, as earlier observed, would also run directly counter to the authoritative statements in Congressional reports explaining the reasons which prompted the Congress to abandon the earlier (World War II) provision broadly granting relief in relation to income from research and development.

## ARGUMENT

### THE TAXPAYER'S INCOME FROM SALES OF THE DRUGS HERE INVOLVED COULD NOT CONSTITUTE "ABNORMAL INCOME" WITHIN THE MEANING OF SECTION 456(a)(2) OF THE INTERNAL REVENUE CODE OF 1939 AND HENCE COULD NOT QUALIFY FOR KOREAN WAR EXCESS PROFITS TAX RELIEF UNDER SECTION 456

#### I. THE TERMS OF SECTION 456(a)(2), VIEWED IN THE LIGHT OF THE KOREAN WAR EXCESS PROFITS TAX LAW AS A WHOLE AND OF THE CLEARLY EXPRESSED CONGRESSIONAL INTENT, ESTABLISH THAT INCOME FROM THE SALE OF PRODUCTS (SUCH AS THE DRUGS HERE INVOLVED) RESULTING FROM RESEARCH AND DEVELOPMENT IS NOT ENTITLED TO RELIEF AS ABNORMAL INCOME FROM "EXPLORATION, DISCOVERY, OR PROSPECTING"

The sole issue in this case concerns the treatment to be accorded to the taxpayer's income from the sales of the drugs Banthine and Dramamine for the purposes of the so-called Korean War Excess Profits Tax Law (Subchapter D, which was added to Chapter 1 of the 1939 Code[1] by the Excess Profits Tax Act of 1950, c. 1199, 64 Stat. 1137, Sections 430, *et seq.* of the Code (Appendix, *infra*, pp. 2a–29a)). More specifically, the question is whether that income can

[1] All Code references herein are to the Internal Revenue Code of 1939.

qualify for excess profits tax relief under Section 456 (Appendix, *infra*, pp. 24a–29a).

The facts are not in dispute (R. 49–53). They establish (R. 41–43, 50) that the chemical drug compounds Banthine and Dramamine were developed from and arose out of research activities conducted by the taxpayer before 1950 (over a period of more than twelve months) and that they were not in existence prior to their preparation by the taxpayer through experiments with various chemical formulae. It is also undisputed that, in the years immediately following the commercial introduction of Dramamine in 1949 and of Banthine in 1950, the taxpayer derived substantial income (running into millions of dollars annually) from sales of those products (R. 13). For present purposes, we do not question the novelty and usefulness of the drugs in question or the scope and intensity of the research effort leading to their development.

The Korean War Excess Profits Tax Law taxed at high rates all corporate profits in excess of a certain norm or level, called the "excess profits credit", deemed to represent the taxpayer's "normal" profits. The credit was to be computed either upon the basis of the taxpayer's average earnings during a specified prior period (called the "base period", generally the years 1946 through 1949) or upon the basis of invested capital, whichever resulted in the lesser tax—except that the law contained numerous provisions dealing with special situations or granting "relief" for "hardship" cases.[8] The present case involves one

[8] A more detailed analysis of the statute appears *infra*, pp. 55–65.

of the provisions (Section 456) under which relief was provided with respect to "abnormal" income received during the taxable year—the relief granted being by way of a computation designed to alleviate the burden of the excess profits tax for the taxable year by permitting the reallocation of certain portions of the abnormal income from the years of its realization to the other years to which it was really attributable.

The taxpayer seeks to apply Section 456 to its income resulting from the sales of its new products. The Government urges, on the contrary, that the relief provisions of Section 456 cannot be applied to income resulting from the sale of tangible personal property reflecting new products, industrial expansion, or the like.[9]

In Section 456(a)(2), the term "abnormal income" is restricted to income of the following designated classes:

> (A) Income rising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or
>
> (B) Income resulting from exploration, discovery, or prospecting, or any combination of

[9] As more fully shown, *infra*, pp. 61–65, the Korean War Excess Profits Tax Law contained other provisions—entirely separate and distinct from Section 456—specifically designed to accord some relief to corporations which, like the taxpayer, experienced unusual growth during and immediately after the statutory "base period" by reason of expansion, increased production capacity, or introduction of new products. See Sections 435(e), 443, and 444 (Appendix, *infra*, pp. 10a–13a, 14a–17a). Generally, under the World War II law such claims had been asserted under Section 721(a)2(C) and Section 722(b)(4).

the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

Each of the designated classes, it should be noted, consists of a non-recurring type of income which is established or ascertainable without undue difficulty under settled concepts, and the mathematical or "automatic" relief formula of Section 456 is readily applicable to income falling within those classes.

Thus, the existence and the amount of a "claim, award, judgment, or decree" are readily ascertainable—generally, by the amount of the actual payment or by documents fixing the rights thereto. Similarly, income resulting from the sale of patents, formulae, or processes,[10] and income includible in gross income for a particular year by reason of a change in accounting methods can be readily determined. The same is generally true of income resulting from "exploration, discovery, or prospecting" of natural resources. (See Rev. Rul. 236, 1953–2 Cum. Bull. 236 (Appendix, *infra*, pp. 47a–52a); see, also, Sections 23 (ff),[11] 105, and

[10] In some situations the terms of a particular sale of a patent might provide for future royalty payments, but the sale itself would normally be a non-recurring event.

[11] Subsection (ff) was added to Section 23 by Section 342(a) of the Revenue Act of 1951, c. 521, 65 Stat. 452.

114(b) of the Code. The "discovery value" of natural resources is a well-established tax concept, and, under specific provisions of the Code and of the Regulations, it may be mathematically computed. See Treasury Regulations 130, Section 40.456–7.

In enacting the Korean War Excess Profits Tax Law, Congress recognized that the relief provisions of the Second World War Excess Profits Tax Law (Subchapter E, added to Chapter 2 of the 1939 Code by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, Sections 710, *et seq.*, Appendix, *infra*, pp. 29a–46a) had caused extended delay in the settlement of claims and that the exercise of subjective judgments in administering the relief provisions of that law had given rise to numerous complaints. (See H. Rep. No. 3142, 81st Cong., 2d Sess., pp. 16–17 (1951–1 Cum. Bull. 187, 197–198); S. Rep. No. 2679, 81st Cong., 2d Sess., pp. 17–18 (1951–1 Cum. Bull. 240, 251–252).) Consequently, in the Korean War law Congress reduced to a minimum the amount of administrative discretion involved in the relief provisions and substituted an entirely different approach to the grant of relief—one broadly rested upon the application of prescribed mathematical formulae.

In Section 721 of the Code (Appendix, *infra*, pp. 37a–40a)—the World War II provision granting relief with respect to "abnormal" income received during the taxable year—the definition of "abnormal income" had included (section 721(a)(2)(C)) income resulting from "research, or development of tangible

property, patents, formulae, or processes".[12] In the Korean War law, in Section 456 (the counter-part to World War II Section 721), that classification was deliberately eliminated because Congress had concluded that "there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law * * * and because the need for a reallocation of such income seemed to be materially less than for the other classes of income described above". S. Rep. No. 2679, 81st Cong., 2d Sess., p. 14 (1951–1 Cum. Bull. 240, 249). Relief under Section 456(a)(2) was accordingly restricted to the four classifications noted above. Thus, both the Commissioner and the courts were relieved of the burden of determining what was an invention, formula or process resulting from research or development and what merely was a minor improvement, a mechanical change, etc.[13]

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[12] The complete provision of Section 721(a)(2)(C) was as follows:

> (C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months, * * *.

[13] Note that in Section 435(e)(1)(B), one of the provisions granting favorable treatment to "growth" businesses, the problem of establishing whether a particular product was an invention, etc., was avoided by the statutory phraseology limiting relief to cases where—

> (ii) 40 percentum or more of the taxpayer's net sales for the calendar year 1950 is attributable to a product, or class of products * * * of a kind not generally avail-

In this setting, the court below was clearly in error in concluding (R. 52–53) that the taxpayer's income from the sale of the drugs in question during the taxable years can qualify as income from a "discovery" within Section 456(a)(2)(B). Its error is primarily the result of isolating the word "discovery" from its context in the statutory phrase "exploration, discovery, or prospecting" and interpreting it in accordance with what the court regarded as its dictionary meaning, *i.e.*, "Finding out or ascertaining something previously unknown or unrecognized; as Curie's *discovery* of radium". (R. 52.) However, the same authority (Webster's New International Dictionary, Unabridged (Second ed.), p. 745) defines "discovery" as an "Act, fact, process, or instance of discovering" and, in addition to the example selected by the Seventh Circuit as the "common accepted meaning", lists others drawn from the fields of geography, science, drama and law, among others, including: "5. *Mining.* The original finding of part of a vein or lode. It is a prime requisite in the valid location of a mining claim." At best, the dictionary definitions of the term "discovery" are inconclusive, since many different meanings are apparent. See the opinion of the First Circuit in *Polaroid Corp.* v. *Commissioner*, 278 F. 2d 148, 151–152, No. 169, this Term, reaching

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able to the public at any time prior to January 1, 1946 * * *.

The amount of the relief provided for taxpayers qualifying under Section 435(e) also was set forth in terms of a mathematical formula.

a conclusion directly opposed to the Seventh Circuit's views."[14]

Since the word "discovery" in Section 456(a)(2)(B) appears between the words "exploration" and "prospecting", its meaning cannot be determined in isolation, especially since each of the three connected nouns has a "readily apparent common denominator" (278 F. 2d., at 152), *i.e.*, natural resources, or the natural resources industries.

The Seventh Circuit's analysis (R. 52–53) of a portion (p. 13) of H. Rep. No. 3142, *supra*—the only legislative material to which it refers—shows, we believe, that the court misunderstood what Congress was seeking to do in the Korean War law. The court below recognized (R. 52) that the elimination of relief for the "research" and "development" class of income (relief which had been granted in Section 721(a)(2)(C) of the World War II law) "served the Congressional objective" of plugging a loop-hole. However, it erroneously concluded (R. 52–53) that "the plugging of the loophole which existed under a former Act because of the use of the unqualified terms 'research' and 'development' does not require that the word 'discovery' which the Congress saw fit to re-employ in the latter enactment [Section 456] be regarded as having taken on the limited and qualified meaning the Government would ascribe to it."

We do not suggest that "discovery" has taken on any new meaning in the Korean war law, but, rather,

[14] A conclusion similar to that of the First Circuit was reached in *Specialties, Inc.* v. *United States*, 174 F. Supp. 89, 94 (E.D.N.Y.).

that it is used there in the same sense in which the term has been employed in the tax laws since 1918 (particularly when used in association with "exploration" and "prospecting"), namely, to refer to the natural resources industries. (See *infra*, pp. 18–55.) In both H. Rep. No. 3142, 81st Cong., 2d Sess., p. 13 (1951–1 Cum. Bull. 187, 195) and S. Rep. No. 2679, 81st Cong., 2d Sess., p. 19 (1951–1 Cum. Bull 240, 249), Congress made it plain that it proposed to eliminate the World War II provision which had granted relief to income "resulting *from the sale of tangible property* arising out of research and development" (emphasis supplied). It did so for these reasons: (1) that that "provision in the old law was a potential loophole of major dimensions";[15] (2) that there "seemed to be materially less" need for relief for income of that type; and (3) that there seemed to be "no means of restricting" such relief "to truly meritorious cases" other than by resorting to the "administrative discretion" method of relief prevalent under the World War II law.

In the absence of any acceptable alternative for the benefit of meritorious "research" and "development" cases, Congress decided to close the loop-hole by eliminating from the Korean War relief provisions those items requiring subjective or discretionary judgment for appropriate administration, namely, all income "resulting *from the sale* of tangible property arising out of research and development". Significantly, Congress retained a provision for relief in respect to one segment of the broader category con-

[15] This "potential loophole" is discussed further *infra*, pp. 66–67.

tained in Section 721(a)(2)(C) covering all income resulting from "research, or development of tangible property, patents, formulae, or processes". The limited retention of this one segment—income from the sale of "patents, formulae, or processes" *themselves* (Section 456(a)(2)(C))—can be explained only by the consideration that the income from the sale of patents, formulae, or processes is readily ascertainable—like the income of the other classes for which Congress determined to retain relief in the Korean War law. See *supra,* pp. 10–12; see, also, *Polaroid Corp.* v. *Commissioner, supra,* 278 F. 2d at 153.

Under the Seventh Circuit's interpretation, the meaning of "exploration, discovery, or prospecting"—characterized by the First Circuit in *Polaroid* (p. 154) as "well-recognized words of art" in the tax law—would be distorted, the potential loop-hole would be reopened, and the basic Congressional purpose of doing away with difficult discretionary judgments (H. Rep. No. 3142, *supra,* pp. 16–17; S. Rep. No. 2679, *supra,* pp. 17–18) would be thwarted. It may be noted, in this connection, that in remanding this case to the District Court, the Seventh Circuit did not suggest any criteria for determining which inventions, formulae, processes, etc. are "actually discoveries", *i.e.,* real inventions, and which are mere improvements or mechanical changes from existing knowledge. Nor has the court below indicated a method for determining how much of the taxpayer's income is due to the fact of invention and how much to manufacturing know-how or skills, sales promo-

tion, and similar elements of business success. The inevitable result of the Seventh Circuit's approach would be precisely what Congress explicitly intended to avoid in the Korean War law: it would plunge the courts into the same mass of technological, economic, accounting and statistical data employed for the administrative determination of excess profits tax relief under the unsatisfactory and deliberately abandoned scheme of the Second World War law.[18]

II. THE LEGISLATIVE HISTORY ESTABLISHES THAT, IN INCLUDING INCOME RESULTING FROM "EXPLORATION, DISCOVERY, OR PROSPECTING" AMONG THE CLASSES OF "ABNORMAL INCOME" ACCORDED SPECIAL TREATMENT UNDER SECTION 456, CONGRESS USED THOSE TERMS IN THE SAME SENSE IN WHICH THEY HAVE BEEN EMPLOYED CONSISTENTLY IN INTERNAL REVENUE TAXATION, INCLUDING EXCESS PROFITS TAXATION, SINCE 1918—*i.e.*, WITH REFERENCE ONLY TO THE OIL, GAS, AND OTHER NATURAL RESOURCES INDUSTRIES

The terminology of the provision under which the taxpayer seeks relief was not new to the Excess Profits Tax Act of 1950. The words "exploration, discovery, or prospecting" were employed in several provisions of the first comprehensive excess profits tax statute, the Revenue Act of 1918, c. 18, 40 Stat. 1057, in order to grant relief to the oil, gas, and mining industries. Since 1918, the same phrase, with occasional variations, has been used repeatedly

[18] Consistently with our view of the statute, Treasury Regulations 130, Section 40.456-2(b) (Appendix, *infra*, pp. 46a–47a) provides:

> Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. * * *

in the several excess profits tax statutes and in other Revenue Acts, again with reference only to those natural resources industries. In the area of taxation, the terms have indeed become "well-recognized words of art." *Polaroid Corp.* v. *Commissioner*, *supra*, 278 F. 2d at 154. Neither the phrase "exploration, discovery, or prospecting", nor any of those individual words, has appeared in the tax statutes with reference to inventions, patented drugs, chemical formulae, or processes.

In the sections which follow, we undertake to describe the essential features of the various excess profits tax statutes which have been passed by the Congress during the two World Wars and during the Korean conflict, and to trace the lines of development. We do not confine ourselves to those provisions which bear directly upon the concept of abnormal income resulting from discovery, but seek also to provide information as to the scheme of the various statutes in order to sketch the general background against which the particular problem presented is to be viewed.

A. *During the World War I period, the excess profits tax provisions accorded special treatment to revenue from exploration, discovery or prospecting only with respect to mines and oil and gas wells, granting entirely separate discretionary relief in other meritorious cases*

1. The 1917 Acts

The Act of March 3, 1917, c. 159, 39 Stat. 1000, contained a very brief excess profits tax provision, imposing (Section 201) an additional tax upon the net income of corporations and partnerships in ex-

cess of a specific sum and of a certain percentage of "the actual capital invested". The computation of this tax was tied in with the income tax, including the special depletion provisions for taxpayers in the natural resources industries,[17] pursuant to Section 203. See also Sections 204, 205 and 206. This Act was in effect for only a few months and was replaced by the Revenue Act of 1917, c. 63, 40 Stat. 300, enacted October 3, 1917, Title II of which comprised a much more complete "War Excess Profits Tax".

The Revenue Act of 1917 imposed (Section 201) on every corporation, partnership or individual an additional tax upon net income in excess of "the deduction"—defined (Section 203) as a specific sum, plus a percentage of invested capital (dependent upon the pre-war rate of return on invested capital). Special provisions were made for relief, as to both "the deduction" and the invested capital, where the statutory criteria were inapplicable (Sections 203(d), 209, and

[17] The peculiar problems of the mining industry due to wasting assets were recognized in the initial income tax law (Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, Section II G), which provided for "a reasonable allowance for depletion of ores and all other natural deposits". See Treasury Regulations 33 (1914 ed.), Arts. 139–145, implementing the statutory provisions concerning depletion in the natural resources industries and contrast Arts. 137–138, providing for the allowance for depreciation of patents on a cost basis prorated over a 17-year period.

Those problems were similarly recognized, with further limitations, in the Revenue Act of 1916, c. 463, 39 Stat. 756, Section 5(a).

The aggregate depletion deductions allowable under both the 1913 Act (see Treasury Regulations 33 (1914 ed.), Art. 142) and the 1916 Act were limited to the taxpayer's investment in the property (cost) or its 1913 value.

210), or the corporation was not in existence during the pre-war period (Section 204), or had little or no pre-war net income or an unusually low pre-war return on invested capital (Section 205(a)). It is notable that virtually from the beginning of excess profits taxation special relief has been provided for businesses whose earnings were unusually or abnormally low during the pre-war period, and that the grant of such relief depended upon non-reviewable administrative findings of the Secretary of the Treasury.[18] Sections 203(d), 205 and 210. See, also, *Williamsport Co.* v. *United States,* 277 U.S. 551. In the same 1917 Act, Congress recognized the indefinite and speculative value of patents, trade-marks, and copyrights by specifically limiting the values accorded such assets in the computation of invested capital for excess profits tax purposes. Section 207; see Regulations 41 (1918 ed.), Arts. 56 and 59.[19]

[18] The relief provisions of this early statute were liberally construed. See Treasury Regulations 41, promulgated under the Revenue Act of 1917, Art. 52.

[19] The excess profits tax provisions of the Revenue Act of 1917 were coordinated with the other internal revenue laws in effect at the time. Section 212. See fn. 17, *supra*, p. 20, with respect to the provisions of the Revenue Act of 1916 for depletion allowances in the cases of oil and gas wells and mines. Treasury Regulations 33 (1918 ed.), implementing the Revenue Act of 1916, *supra*, as amended by the Revenue Act of 1917, *supra*, contained detailed provisions for the computation of depletion allowances for oil and gas properties (Art. 170), mines or mineral properties (Arts. 171–172), or timber (Art. 173) on a basis of recovery of cost or fair market value as of March 1, 1913. In contrast, the Regulations with respect to the depreciation of patents provided (Art. 174): "In determining the amount deductible on

2. The Revenue Act of 1918

The Revenue Act of 1918, c. 18, 40 Stat. 1057, included as Title III a "War-Profits and Excess-Profits Tax". This Act, drafted after experience under the prior statutes, contains many concepts which have survived and have been incorporated in the most recent excess profits tax laws, including provision for the special treatment of the oil, gas and other natural resources industries.

The excess profits tax provisions of the Revenue Act of 1918 were again coordinated specifically with the income tax sections. Sections 320(a)(3) and 336. The tax, imposed only on corporations, applied to the years 1918 and 1919 and was computed by a rather complicated formula based primarily upon percentages of invested capital. Sections 301 (a) and (b); 302; 311(a); 312. Special methods of computation were authorized for corporations which were non-existent or had little or no net income during the pre-war period. Section 311 (b) and (c). Discretionary relief was provided under Sections 327 and 328 for hardship cases and situations where invested capital could not properly be determined.

Sections 327 and 328 were intended to broaden the relief powers previously conferred by Section 210

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account of the expiring life of patents only the actual cost thereof and not an estimated value as of March 1, 1913, or any other date, will be considered." See Regulations 41 (1918 ed.), Art. 42, requiring the consideration of reasonable allowances for depletion, depreciation and obsolescence in the computation of invested capital under the War Excess Profits Tax provisions of 1917.

of the War Revenue Act of 1917, *supra*.[20] *Williamsport Co.* v. *United States*, 277 U.S. 551, 558. Because of the possibility that the normal method of computing the tax might place a premium on overcapitalization in some cases and result in extreme hardship in others, it was believed "necessary to provide a special method of determining the tax for those cases in which the ordinary method of assessment would result in grave hardship or serious inequality." S. Rep. No. 617, 65th Cong., 3d Sess., p. 14 (1939–1 Cum. Bull. (Part 2) 117, 127). In the view of Congress, "No part of Title III [the excess profits tax provisions] is as important as the so-called relief provisions." S. Rep. No. 617, *supra*, p. 14. The relief granted in Sections 327 and 328 was highly discretionary, and both the propriety of relief for particular taxpayers and the amount of such relief depended upon judgments of the Commissioner of Internal Revenue with respect to matters not entirely subject to proof or disproof. The Commissioner's determinations, moreover, were not subject to review in the courts. See *Williamsport Co.* v. *United States, supra*; *Heiner* v. *Diamond Alkali Co.*, 288 U.S. 502; and *Welch* v. *Obispo Oil Co.*, 301 U.S. 190.

In the same Act, the peculiar problems of the oil, gas and mining industries under excess profits tax-

[20] The expansion of the relief provisions in the 1918 Act was summarized in H. Rep. No. 767, 65th Cong., 2d Sess., pp. 19–20 (1939–1 Cum. Bull. (Part 2) 86, 99–100).

ation were recognized.[21] Section 337 of the excess profits tax title provided:

> That in the case of a bona fide sale of *mines, oil or gas wells*, or any interest therein, *where the principal value of the property has been demonstrated by prospecting or exploration and discovery work* done by the taxpayer, the portion of the tax imposed by this title attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest. [Emphasis added.]

Section 211(b) of the income tax provisions of the Revenue Act of 1918, which limited the surtax rate, was identical.[22]

S. Rep. No. 617, 65th Cong., 3d Sess., p. 6 (1939–1 Cum. Bull. (Part 2) 117, 120–121), contained the following explanation of these provisions:

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[21] The statute's special provisions regarding income from patents and secret processes were contained in Section 326(a)(4) and (5), limiting the valuation in the computation of "invested capital" to be placed on "intangible property" paid in for stock. "Intangible property" was defined as "patents, copyrights, secret processes and formulae, good will, trade-marks, trade-brands, franchises, and other like property". Section 325(a). S. Rep. No. 617, 65th Cong., 3d Sess., p. 14 (1939–1 Cum. Bull. (Part 2) 117, 126–127), states in this connection: "Patents and copyrights give rise to as much abuse in connection with overcapitalization as other forms of intangible property".

[22] See Regulations 45 (1920 ed.), Arts. 13 and 971–972, with respect to the computation of the surtax and excess profits tax upon the sale of mineral deposits discovered by the taxpayer. Compare Art. 40, as amended by T.D. 3206, 5 Cum. Bull. (1921) 87, 88, providing for the tax on income from the sale of patents on the basis of the difference between the sale price and the cost or March 1, 1913, value, less depreciation, which makes no reference to the concept of discovery value.

Gains Derived From Prospecting, Exploration, or Discovery

> The prospector for mines or oil and gas frequently expends many years and much money in fruitless search. When he does locate a productive property and comes to settle it seems unwise and unfair that his profit be taxed at the maximum rate as if it were ordinary income attributable to the normal activities of a single year. *To stimulate prospecting and exploration, the committee has limited the surtax to 20 per cent of the selling price in the case of a bona fide sale of mines, oil or gas wells where the principal value was demonstrated by prospecting, exploring, or discovery work done by the taxpayer* (sec. 211b, p. 18). A similar limitation has been imposed by the war excess-profits tax applicable to gains derived by a corporation from the bona fide sale of such mines, oil or gas wells (sec. 337, p. 107). Special provision is also made for increased depletion allowance in the case of such properties (sec. 214 (10), p. 28; and sec. 234(9), p. 58). [Emphasis added.]

In the Conference Report, the House agreed to the addition of Sections 211(b) and 337, providing relief to the mining, oil and gas industries with respect to both surtax and excess profits rates. H. Conference Rep. No. 1037, 65th Cong., 3d Sess., pp. 47, 70 (1939-1 Cum. Bull. (Part 2) 130, 134, 150).

The Congressional Hearings concerning Sections 211(b) and 337 of the Revenue Act of 1918 contain further explanation of the Congressional purpose to aid the oil, gas and mining industries by the enact-

ment of those sections.[23] The relief provisions in question were adopted initially when many minerals were needed urgently for war purposes. The representatives of the oil industry informed the Congress that increased production of oil depends largely upon the encouragement of exploration and prospecting since the production of existing wells necessarily declines from the beginning.[24] As a result of the high surtax and excess profits tax rates, "wildcatters" or prospectors who had discovered oil were being discouraged from the usual practice of selling their discovered wells to developers and engaging in further

[23] See, generally, Senate Hearings, Revenue Act of 1918, pp. 356–393; House Hearings, Revenue Act of 1918, Part I, pp. 437–528.

[24] The representative of the National Petroleum War Service Committee stated (Senate Hearings, Revenue Act of 1918, p. 357): "* * * unless in the precarious enterprise of crude-oil production, which does not depend upon anything else except new discovery and new development, there is a fair encouragement of new development; an opportunity for that exploration which makes what is known as the 'wildcatter' in the oil world, precisely the same as the 'prospector' in the mining world, this country unquestionably, if the figures of the oil producers of the United States are accurate, faces a genuine and serious shortage in crude oil, at a time when we are fast demanding a very much increased supply for the manifold necessities of ourselves and our allies across the seas". The statement of the Mid-Continent Oil & Gas Association and the Texas Gulf Coast & Louisiana Oil & Gas Association cautioned (Senate Hearings, Revenue Act of 1918, p. 392): "It is proper and necessary in the consideration of this legislation from any angle to keep in mind the fact that the production of all wells rapidly declines from the beginning."

exploration.[25] The solution adopted in Sections 211(b) and 337 of the Revenue Act of 1918, in accordance with the recommendations of the oil and gas industry,[26] was the placing of a limit on the surtax and excess profits tax rates applicable to sales of discovered mines, oil or gas wells. As demonstrated more fully in Point II B, *infra*, pp. 32–37, these pro-

[25] The statement of the Mid-Continent Oil & Gas Association and the Texas Gulf Coast & Louisiana Oil & Gas Association with respect to this problem was (Senate Hearings, *supra*, p. 391): "One of the characteristic and essential features of oil and gas producing is the individual or concern of small means engaged in prospecting. The flowing well is the rare exception and, as a rule, after the discovery of a producing property a large additional investment is necessary for development. It has been customary for the small operator to borrow through local banks this necessary money, both banker and operator knowing that the income from the property can not be expected to pay the loans when due, or even within a period proper and suitable for loans by banks of that type. In the past this has been possible because the operator has purposed selling the property when it had reached a suitable point of development, but treatment of all of the profits as income in the one year in which the sale is made and as subject to the existing excess profits tax rates has stopped all sales of producing oil properties and is thus inevitably stopping prospecting by individuals and concerns of small means. The House bill with its increased rates under either alternative would greatly accentuate this unfortunate situation".

[26] The statement of the oil and gas associations quoted in the preceding two footnotes concluded (Senate Hearings, Revenue Act of 1918, pp. 392–393): "In view of the importance and close relationship existing between sales of producing oil and gas properties and the continuance of the drilling in search of new production so vitally necessary to the prosecution of the war, the net income derived from such sales, bona fide made, where not more than a 50 percent interest is retained by the seller, should not be subjected to a greater tax than 20 percent".

visions have been retained as a form of special relief for the mining, oil and gas industries, almost without interruption, in all the revenue laws of the succeeding years with respect to both income taxes and excess profits taxes. Thus, Section 105 of the 1939 Code (Appendix, *infra*, p. 1a) is virtually identical, even in terminology, with Section 211(b) of the Revenue Act of 1918. Section 456(a)(2)(B) of the 1939 Code is the companion excess profits tax provision, modified in accordance with the altered statutory framework and expanded to cover the gradual sale of the wasting asset.[27]

The Revenue Act of 1918 also provided for the allowance of depletion deductions in the case of mines, oil and gas wells, other natural deposits, and timber, and stated that in certain cases the depletion allowance, for mines, oil and gas wells only, shall be based

[27] It may be noted that the income tax provision, Section 105 of the 1939 Code, does not reflect an expansion similar to Section 456(a)(2)(B) so as to cover the gradual sale of the wasting asset—for the obvious reason that no similar expansion was necessary for income tax purposes in view of the intervening marked expansion of the percentage depletion provisions, which appeared in Section 114(b)(3) and (4) of the 1939 Code.

It may be added that, of course, for present purposes, far more significant is the direct relationship in the terminology between Section 456(a)(2)(B) and Section 721(a)(2)(C) of the 1939 Code and Section 327 of the 1918 Act.

In this connection, it might also be pointed out that there is no direct correlation between Sections 456(a)(2)(B) and 721(a)(2)(C) of the 1939 Code and Sections 327(d) and 328 of the 1918 Act—since the latter were the original broad general relief provisions in the World War I Excess Profits Tax Law, the general concept of which found its way really into Section 722 of the World War II law.

upon discovery value. Section 234(a)(9), concerned with the computation of the net income subject to the tax on corporate revenue, allowed as a deduction:

> In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or* within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *. [Emphasis added.]

Section 214(a)(10) was identical with respect to the deduction allowed persons other than corporations.[22]

[22] See Treasury Regulations 45 (1920 ed.) Arts. 201–226, the detailed Regulations concerning discovery depletion applicable to mines and oil and gas wells. Compare Art. 167, providing for the depreciation of patents on a cost or March 1, 1913, value (the latter applicable "only when affirmative and satisfactory evidence of such value is offered") without reference to discovery value.

In S. Rep. No. 617, 65th Cong., 3d Sess., p. 8 (1939–1 Cum. Bull. (Part 2) 117, 122), it was explained:

> For the purpose of depletion allowance in the case of properties acquired prior to March 1, 1913, the provision of the present law, omitted in the House bill, has been restored by the committee, so that in the case of such properties the basis for the depletion allowance shall be the March 1, 1913, valuation; but a proviso has been added that where mines or oil and gas wells have been discovered by the taxpayer on or after March 1, 1913, and not acquired as a result of the purchase of a proven tract or lease, and where the fair market value is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery or within 12 months thereafter (sec. 214a, 10, and sec. 234a, 9).[29]

Section 234(a)(9) of the Revenue Act of 1918 was enacted as part of the Congressional program to obtain increased oil production by providing incentives to "wildcatters" or prospectors. See footnotes 24 and 25, *supra*. Previously, although a "wildcatter" had experienced great losses in prior years, he was taxed at high rates on all income in excess of his immediate expense in the year of his discovery. The oil industry representatives had suggested that this inequity be remedied by allowing depletion on the

[29] The House receded from its more limited relief provision with an amendment changing the valuation period from 12 months to 30 days. (H. Conference Rep. No. 1037, *supra*, p. 50 (1939–1 Cum. Bull. (Part 2) 130, 136).

basis of discovery value rather than cost, or by permitting the carry-over of costs.[30]

To provide equitable tax treatment of prospectors, the concept of depletion on the basis of discovery value (Sections 214(a)(10) and 234(a)(9), Revenue Act of 1918, *supra*) has been retained in succeeding revenue laws, and the suggestion of the oil industry in 1918 that costs be carried over against future income was

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[30] The Oil and Gas Producers' Association of West Virginia recommended (House Hearings, Revenue Act of 1918, Part I, pp. 497–498):

> As it requires the investment of capital at great risk to determine the value of prospective oil or gas properties, such properties should be valued after oil or gas has been discovered thereon for the purpose of taxation. This would give the prospector an incentive by giving him some benefit or credit for the increased valuation which he might create at the risk of losing his investment. * * *

The recommendation of the Mid-Continent Oil & Gas Association and the Texas Gulf Coast and Louisiana Oil & Gas Associations was as follows (Senate Hearings, Revenue Act of 1918, p. 393):

> 6. Under existing law and the Regulations of the Treasury Department, the cost of discovery of deposits of petroleum—that is, money spent in unsuccessful prospecting and drilling dry holes—must be treated as a loss, unless there is sufficient income during the taxable year to permit its deduction as an expense.
>
> Obviously, this is a great and unjustifiable hardship and burden to the taxpayers engaged in such a hazardous and uncertain industry, the returns from which are so necessarily irregular that several years of losses frequently intervenue between profitable discoveries.
>
> Clearly, money so expended in such an industry should either be treated as capital invested and returnable through depletion or as an expense to be deducted from income when the same is attained in some subsequent year.

adopted later in excess profits taxation.[31] Section 114(b)(2) of the 1939 Code (Appendix, *infra*, pp. 1a–2a) allows depletion based on discovery value. In Section 456(a)(2)(B) of the 1939 Code, the same concept is applied: Companies in the extractive industries are permitted to attribute to other years certain excess profits to the extent of the discovery value of their properties. See also Section 721(a)(2)(C) of the 1939 Code.

Examination of the Revenue Act of 1918 and of its extensive legislative history thus clearly demonstrates that the concept of special treatment of income derived from "exploration, discovery, or prospecting" was adopted for the explicit purpose of aiding the natural resources industries. The statutory terms have not been changed, and the relief in question remains applicable only to these industries.

B. *In the period between the two World Wars, the 1918 provisions for special treatment of income from exploration, discovery and prospecting were retained in the income tax laws through 1938, and applied only to the natural resources industries*

1. Provisions for taxation of proceeds from the sale of discovered mining, oil, or gas properties

The provisions of Sections 211(b) and 337 of the Revenue Act of 1918 limiting the tax on the proceeds from the sale of discovered mining, oil or gas properties, were retained as Sections 211(b) and 337 of the Revenue Act of 1921, c. 136, 42 Stat. 227, Title III of which imposed, for the year 1921, a tax similar to

[31] See Section 433(b)(9)(B) (Appendix, *infra*, p. 7a) and Section 711(b)(1)(I) (Appendix, *infra*, p. 32a) of the 1939 Code.

the 1918 excess profits tax provisions. This section was re-enacted, virtually without change, as Section 211(b) of the Revenue Acts of 1924, c. 234, 43 Stat. 253, and 1926, c. 27, 44 Stat. 9, and as Section 102(a) of the Revenue Acts of 1928, c. 852, 45 Stat. 791, and 1932, c. 209, 47 Stat. 169.

In the Revenue Act of 1934, c. 277, 48 Stat. 680, the provision in question was omitted because overproduction in the oil and gas industries made the encouragement of prospecting undesirable.[32]

However, in the Revenue Act of 1936, c. 690, 49 Stat. 1648, the provision limiting the tax on the proceeds from sales of discovered oil and gas properties was reinstated, as Section 105, with a 30 percent limit on the rate of tax. The Senate Finance Committee's Report (S. Rep. No. 2156, 74th Cong., 2d Sess., p. 18 (1939–1 Cum. Bull. (Part 2) 678, 689)) explained the application of the reinstated provision as follows:

> The bill as reported inserts a provision not found in the House Bill but similar to provisions contained in Revenue Acts prior to 1934, limiting the surtax in cases of taxpayers who sell oil or gas property where the principal

[32] H. Rep. No. 704, 73d Cong., 2d Sess., p. 25 (1939–1 Cum. Bull. (Part 2) 554, 572), states:

> This provision apparently was inserted in the law to encourage the development of new mines and oil wells. In the present state of overproduction there is no need to continue this provision.

S. Rep. No. 558, 73d Cong., 2d Sess., p. 30 (1939–1 Cum. Bull. (Part 2) 586, 609), states:

> In the present state of overproduction there is no need to continue this provision, which taxes large profits from the sales of certain kinds of property on a different basis from that applicable to property generally.

> value of the property has been demonstrated by *prospecting* or *exploration* and *discovery* work done by the taxpayer. The effect of the provision is to limit the surtax on that portion of the individual's net income attributable to the sale of such properties to not more than 30 percent of the selling price of the property or interest. It was brought to the attention of the committee that the effect of the omission in the 1934 act of a similar provision was, in many cases, to prevent the sale of such properties and thus a tax loss has resulted and individuals have been discouraged from embarking upon or continuing such enterprises. The result was to throw the business into the hands of corporations which, being subject only to the corporation-tax rate, would pay less tax than individuals would. It is believed that the result of the proposed change will be to stimulate individuals to develop oil and gas properties and to sell, thus increasing the tax yield from this source. [Emphasis supplied.]

The 1936 provision was retained as Section 105 of the Revenue Act of 1938, c. 289, 52 Stat. 447,[33] and finally appeared as Section 105 in the 1939 Code.

It is notable that, throughout the long history of this relief provision of the tax laws, it always has been applied (S. Rep. No. 2156, *supra*) "where the principal value of the property has been demonstrated by *prospecting or exploration and discovery work*

[33] In the 1936 Act the phrase in question was changed to "prospecting * * * or [instead of "and"] discovery work," and the section as a whole was limited to oil or gas property. As indicated *supra*, it has been carried forward in this form. See also *infra*, pp. 69–72.

done by the taxpayer." [Emphasis added.] The provision never has had reference to relief for any class of taxpayers except discoverers of mines and oil and gas properties, although, as indicated above, the section has been considered and debated many times and always has been couched in the very words on which the taxpayer here relies. Throughout the history of this section, in both the income and excess profits sections of the tax laws, "exploration," "discovery" and "prospecting" have been treated by Congress as *words of art* having application *only* to the mining, oil and gas industries.

2. Provisions allowing depletion of oil, gas, and mining properties on the basis of discovery values

Sections 214(a)(10) and 234(a)(9) of the Revenue Act of 1918, *supra,* which provided for the allowance of a deduction for depletion on the basis of discovery value in the case of mines and oil and gas wells, were retained under the same section numbers in the Revenue Act of 1921, *supra.* The following proviso was inserted in each section:

> * * * *And provided further,* That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913 * * *.

The added proviso was designed to assure that discovery depletion could be applied only to income from

the designated industries and could not be used to offset the income of taxpayers from other businesses.[34]

Section 204(c) of the Revenue Act of 1924, *supra*, limited the discovery depletion allowance with respect to income from mines, oil and gas wells, to not more than 50 per cent of the net income from the property upon which the discovery was made.

The corresponding section of the Revenue Act of 1926, *supra*, Section 204(c)(1), limited discovery value depletion to mines. Depletion of oil and gas wells was allowed on the basis of a percentage of gross income from the property during the taxable year rather than on discovery value. Section 204(c)(2).[35]

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[34] S. Rep. No. 275, 67th Cong., 1st Sess., p. 15 (1939–1 Cum. Bull. (Part 2) 181, 191), states:

> * * * in order to make it certain that the depletion deduction when based upon discovery value shall not be permitted to offset or cancel profits derived by the taxpayer from a separate and distinct line of business, it is provided that the depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or the fair market value as of March 1, 1913 * * *.

See also H. Conference Rep. No. 486, 67th Cong., 1st Sess., p. 25 (1939–1 Cum. Bull. (Part 2) 206, 215), to the same general effect.

[35] See S. Rep. No. 52, 69th Cong., 1st Sess., pp. 17–18 (1939–1 Cum. Bull. (Part 2) 332, 345–346); H. Conference Rep. No. 356, 69th Cong., 1st Sess., pp. 31–32 (1939–1 Cum. Bull. (Part

The section relating to "Discovery value in case of mines" was re-enacted as Section 114(b)(2) of the Revenue Act of 1928, *supra*. Under the same number, the section remained essentially unchanged in the Revenue Act of 1932, *supra*. Percentage depletion was applied in the case of metal, coal and sulphur mines. Section 114(b)(4).[36] The "discovery value" provision of Section 114(b)(2) was carried forward, slightly clarified, in the Revenue Act of 1934, *supra*, and then re-enacted without change in the 1936 and 1938 Revenue Acts, *supra*, under the same number.

In sum, the concept of allowing a deduction from income for depletion on the basis of discovery value has been a part of the tax laws since 1918. Its only application has been to the mining, oil and gas industries.

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2) 361, 362–363); 67 Cong. Record, Part 3, pp. 3018–3019; Part 4, pp. 3761–3763, to the effect that difficulty had been experienced in administering the discovery value depletion provisions in the case of oil and gas wells because of the policy of attempting to allow depletion on the basis of the ultimate value of the oil or gas in the ground in the case of each well. This abandoned policy may be contrasted with the more flexible and practical present approach of ascertaining the discovery value of oil and gas wells by reference to expert estimates of the value of the pool on the date of discovery in the active and established market for leases of such properties. See Rev. Rul. 236, 1953–2 Cum. Bull. 236.

[36] Percentage depletion provisions, broadly expanded, found their way into the 1939 Code in Section 114(b)(3) and (4).

C. *During the Second World War period, the 1939 Code contained separate provisions for relief, both for income tax and excess profits tax purposes, as to income from exploration, discovery and prospecting with reference only to the natural resources industries—and excess profits tax relief for other taxpayers was provided in other sections, utilizing other terminology*

1. The general pattern of the Second World War Excess Profits Tax Law, and its relief provisions

The Second World War excess profits tax law was patterned to some extent upon the World War I law, though with numerous modifications and additions. That law first appeared in a new subchapter (Subchapter E—Excess Profits Tax) which was added to Chapter 2 of the 1939 Code by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, entitled "Excess Profits Tax Act of 1940," applicable to taxable years beginning after December 31, 1939." In the new subchapter, a tax was imposed by Section 710(a) (Appendix, *infra*, p. 29a) upon the "adjusted excess-profits net income" as defined in Section 710 (b), less the following: (1) a specific exemption (originally $5,000, later $10,000); (2) an "excess profits credit" computed under Section 712 (Appendix, *infra*, p. 33a); and (3) an unused excess profits credit adjustment computed in accordance with Section 710(c).[37] Section 711 (Appendix, *infra*,

[37] This statute was repealed, as to taxable years beginning after December 31, 1945, by Section 122(a) of the Revenue Act of 1945, c. 453, 59 Stat. 556.

[38] Subsection (c) of Section 710 was added by Section 2(b), Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17, and amended by Section 204(b), Revenue Act of 1942, c. 619, 56 Stat. 798.

pp. 30a–33a) provided that the "excess profits net income" shall be the "normal-tax net income" (as defined in Section 13(a)(2) under Chapter 1 of the Code, relating to the income tax), with certain adjustments. Under Section 712(a), a corporation (if in existence prior to 1940) could take an excess profits credit computed either under Section 713 (Appendix, *infra*, pp. 33a–37a) on the basis of average net income during a so-called "base period", generally the years 1936 through 1939 (*ie.*, the "average base period net income", or the ABPNI),[39] or under Section 714 upon the basis of invested capital, whichever resulted in the lesser tax. Sections 715 through 720 contained the formula by which the invested capital credit was to be determined.

Following Section 720 are the provisions dealing with "abnormalities" and special situations. Relief for "abnormalities" was accorded primarily by Section 721, which granted relief with respect to "abnormalities" in income in the taxable year, and by Section 722 (Appendix, *infra*, pp. 41a–44a), which granted relief mainly with respect to "abnormalities" in the base period. In addition, some further relief was provided under Section 711(b)(1)(H), (I), (J), and (K) (Appendix, *infra*, pp. 31a–33a), by way of adjustments to a taxpayer's base period income, for unusual or "abnormal" deductions, etc.[40]

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[39] For the sake of brevity, the initials "ABPNI" have been generally used to refer to the "average base period net income" under Section 713, while the initials "CABPNI" have been used to refer to the "constructive average base period net income" under Section 722.

[40] Subsections (J) and (K) were added to Section 711(b)(1) by Section 3, Excess Profits Tax Amendments of 1941, *supra*.

Viewing the law broadly, it is apparent that it taxed at high rates all profits above a certain level or norm, which was called the "excess profits credit" and which was computed either upon the basis of average income for a specified prior period (called the base period, generally the years 1936 through 1939) or upon the basis of invested capital, whichever resulted in the lesser tax—except that the law contained provisions granting relief from the resultant tax for certain so-called "abnormalities" and special situations.

The principal "abnormalities" provisions of the law (Section 721 and Section 722) were originally added to the Code by the Second Revenue Act of 1940, but they underwent considerable changes in subsequent Acts, being largely amplified by the Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17, and by the Revenue Act of 1942, c. 619, 56 Stat. 798, with further occasional changes being made even thereafter. The relief provisions of Section 722 were finally changed (retroactively, to apply to all taxable years after 1939) by Section 222 of the Revenue Act of 1942, so as to provide, in substance, that a taxpayer could, under certain conditions, obtain relief upon the basis of a "constructive" average base period net income (*i.e.*, a CABPNI) if it could establish that its income during the base period was not normal for any of the reasons specified in the statute and if it could establish "what would be a fair and just amount representing normal earnings". Section 722(a). With respect to the *procedure* for obtaining relief, Section 722 was finally amended by Section 1 of the Act of

December 17, 1943, c. 346, 57 Stat. 601 (also retroactively to apply to all taxable years after 1939), so as to require, in substance, that a taxpayer must first pay its excess profits tax without the benefit of Section 722 and then seek relief under Section 722 by filing a claim therefor pursuant to the provisions of Section 322 of the Code, the so-called "claim for refund" section, "in accordance with regulations prescribed by the Commissioner with the approval of the Secretary". Section 722(d) of the Code. See, also, *Pohatcong Hosiery Mills* v. *Commissioner*, 162 F. 2d 146 (C.A. 3d); *United States* v. *Koppers Co.*, 348 U.S. 254.

In 1941, at the same time that Congress undertook the first major amplification of the two principal "abnormalities" sections (Sections 721 and 722) and added Section 711(b)(1) (J) and (K) in the Excess Profits Tax Amendments of 1941, it also added to the law Section 732(a), (b), and (c) (Appendix, *infra*, pp. 44a–45a) to deal specifically with the review of "abnormalities" questions by the Tax Court (then called the Board of Tax Appeals)[41] and to prohibit expressly the further review by any other court of any decision of the Tax Court on any of the "abnormalities" questions. The intent of Congress to limit the review of "abnormalities" questions was made unmistakably clear by its Committee Reports. H. Rep. No. 146, 77th Cong., 1st Sess., pp. 14–15 (1941–1 Cum.

[41] Previously, the jurisdiction of the Tax Court could be invoked only where the Commissioner had determined a deficiency, pursuant to Section 272 of the Code.

Bull. 550, 560–561), and S. Rep. No. 75, 77th Cong., 1st Sess., pp. 15–16 (1941–1 Cum. Bull. 564, 565). See, also, the series of decisions in the courts of appeals holding that the Tax Court's determinations under the "abnormalities" provisions of the Second World War law are not subject to judicial review. E.g., *Helms Bakeries* v. *Commissioner,* 263 F. 2d 642 (C.A. 9th), certiorari denied, 360 U.S. 903; *L. E. Carpenter & Co.* v. *Commissioner,* 264 F. 2d 230 (C.A. 3d); *United States Rubber Co.* v. *Commissioner,* 274 F. 2d 307 (C.A. 2d), certiorari denied, 363 U.S. 827; *Puget Sound Pulp & Timber Co.* v. *Commissioner,* 277 F. 2d 803 (C.A. 9th), certiorari denied, 364 U.S. 831; *Hewitt-Robins, Inc.* v. *Commissioner,* 282 F. 2d 868 (C.A. 3d).

Subsequently, by Section 222(c) of the Revenue Act of 1942, Congress added subsection (d) to Section 732 of the Code (Appendix, *infra,* pp. 45a–46a) to provide for the review by a "Special Division" of the Tax Court of the decisions by any division of the Tax Court of questions under Section 721(a)(2)(C) or Section 722 of the Code. This new feature was written into the law by Congress because of its awareness of the extremely complicated nature of the problems and issues involved. See H. Rep. No. 2333, 77th Cong., 2d Sess., p. 149 (1942–2 Cum. Bull. 372, 482); S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 206–207 (1942–2 Cum. Bull. 504, 655); *Helms Bakeries* v. *Commissioner,* 236 F. 2d 3 (C.A. 9th).

In view of subsequent developments in the field of excess profits taxation, we examine in greater detail the provisions of Section 713, which provided for an excess profits credit upon the basis of *actual* average

earnings during the base period, *i.e.*, the ABPNI—as distinguished from Section 722, which provided for special relief for "abnormalities" by means of a credit arrived at upon the basis of a *constructive* average income for the base period, *i.e.*, the CABPNI.

The basic plan of Section 713 was to provide for an ABPNI arrived at by means of a computation reflecting the average yearly amount of earnings of a taxpayer for the four base period years—in other words, an arithmetical general average. See Section 713 (d) and (e). However, incorporated into Section 713 were two provisions which were aimed at affording a certain measure of relief in certain situations by means of automatic adjustments to be made in the computation of the ABPNI.

One of these provisions was contained in Section 713(e), with respect to the earnings for the lowest year in the base period, while the other was contained in Section 713(f), with respect to increased earnings in the last half of the base period. Section 713(e), as finally amended by Section 215 of the Revenue Act of 1942, was a provision designed to raise automatically the income for the poorest year in a taxpayer's base period, by the use of the so-called "75% rule"—whereby, if the earnings for one base period year were less than 75% of the average earnings for the other base period years, the earnings of that low year were raised automatically to an amount equal to 75% of the average for the other years.[42] See S. Rep. No. 1631, *supra*, pp. 45, 191

[42] Previously, for taxable years prior to 1942, instead of the "75% rule", Section 713(e) contained the so-called "deficit rule", whereby the largest deficit in any of the base period

(1942–2 Cum. Bull. 504, 541–542, 644); H. Conference Rep. No. 2586, 77th Cong., 2d Sess., pp. 60–61 (1942–2 Cum. Bull. 701, 718). Section 713(f)—adopted (in its final form) by Section 4 of the Excess Profits Tax Amendments of 1941—accorded some relief, also *automatically,* to taxpayers which experienced rapid growth during the base period. As to such taxpayers, Congress adopted the so-called "growth formula", granting a greater credit to corporations with earnings in the second half of the base period exceeding those in the first half—this, in order to reflect more equitably their earning power as of the time the excess profits tax became applicable. See H. Rep. No. 146, *supra,* pp. 3, 6–7 (1941–1 Cum. Bull. 550, 551, 553–554); S. Rep. No. 75, *supra,* pp. 3, 6–7 (1941–1 Cum. Bull. 564, 565).

In this connection, we note that the benefits provided for by the "75% rule" under Section 713(e) and the benefits of the so-called "growth formula" computation under Section 713(f) were alternatives to each other. See Section 713(d). See also S. Rep. No. 1631, *supra,* p. 191 (1942–2 Cum. Bull. 504, 644), and Treasury Regulations 112, Sections 35.713–1 (a) and (c)(2). The benefits of both Section 713(e) and Section 713(f) were, in turn, alternatives to relief under Section 722. In other words, the benefits of the automatic adjustments in the computation of the

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years was eliminated in arriving at the ABPNI. See Section 713(e), as amended by Sections 4 and 17 of the Excess Profits Tax Amendments of 1941, *supra.*

ABPNI under Section 713 and the special relief by means of a CABPNI under Section 722 were mutually exclusive. See *Dowd-Feder* v. *Commissioner,* 173 F. 2d 673 (C.A. 6th); *Dayton Rubber Co.* v. *Commissioner,* 249 F. 2d 2 (C.A. 6th); *United States Rubber Co.* v. *Commissioner, supra.*[43]

As already noted, Section 721 was originally added to the Code by the Second Revenue Act of 1940, later amplified by the Excess Profits Tax Amendments of 1941, and further amended by the Revenue Act of 1942, so as to accord relief to a taxpayer, under certain conditions, with respect to "abnormal" income received during a taxable year but really attributable to other years. The general purpose of Section 721 has been aptly stated to be "to relieve the burden of the excess profits tax in certain hardship cases by permitting the reallocation" of certain portions of the net abnormal income of a taxpayer from the year of its realization to other years to which it is attributable. *Southwestern Oil & Gas Co.* v. *Commissioner,* 6 T.C. 1124, 1129. As originally added to the Code in 1940, Section 721 provided relief with respect only to

[43] Although a taxpayer reconstructing its base period earnings under Section 722 was not entitled to use the "growth formula" as such, it was recognized that, in a proper case, *true growth* could be considered and reflected into a reconstruction of base period earnings to the extent reasonable and consistent with Section 722. See Section 35.722-2(b)(1) of Treasury Regulations 112, as amended by T.D. 5415, 1944 Cum. Bull. 404, and T.D. 5566, 1947-1 Cum. Bull. 72. See also Treasury Department's Bulletin on Section 722 (November, 1944), pp. 154–156.

income falling within any of six specifically enumerated classes, but by the amendments in 1941 the definition of "abnormal income" in Section 721(a)(1) was enlarged so as to embrace income of any other class if it was abnormal for the taxpayer to derive income of such class or if its income of that class for the taxable year was in excess of 125 per cent of its income of the same class for the prior four taxable years.

Both Sections 721 and 722 were broad, general relief statutes, and there was a substantial degree of overlapping of their applicability. Their interrelationship is illustrated by that portion of Section 721(a)(2)(C) affording relief with respect to income resulting from "research, or development of tangible property, patents, formulae, or processes" and by those portions of Section 722(b)(4) granting relief to taxpayers who "either during or immediately prior to the base period * * * changed the character of the business"—particularly with respect to changes in character of the business due to a "change in [method of] operation", a "change in the capacity for production or operation", or due to a "difference in the products or services furnished".[4] Consequently, many taxpayers who claimed relief under Section 721 also made claims under Section 722. See, *e.g.*, *Commissioner* v. *Smith Paper*, 222 F. 2d 126 (C.A. 1st); *Crowell-Collier Publishing Co.* v. *Commissioner*, 259 F. 2d 860 (C.A. 2d), certiorari denied, 358 U.S. 928;

[4] See also Section 721(f); Treasury Regulations 112, Section 35.721-7; Bulletin on Section 722, *supra*, pp. 156–158.

*Don Baxter, Inc.* v. *Commissioner,* 29 T.C. 1027. See also H. Rep. No. 2333, 77th Cong., 2d Sess., p. 24 (1942–2 Cum. Bull. 372, 393). In the litigation of claims for relief under Section 721(a)(2)(C) with respect to new products or processes, it was established that relief under that section involved discretionary determinations similar to those necessary under Section 722. The Tax Court held that the portion of a corporation's increased income due to generally improved business conditions and not attributable to prior years under Section 721 is "a matter of opinion." *Rochester Button Co.* v. *Commissioner,* 7 T.C. 529, 553; *Pantasote Leather Co.* v. *Commissioner,* 12 T.C. 635. The discretionary nature of relief under Section 721(a)(2)(C) was emphasized further by the Tax Court's rulings that the allocation of profits as resulting from "research, or development" or from such nonqualifying factors as management, sales efforts, efficient use of physical facilities, etc., must be made "by exercising common sense and judgment," and that "It is entirely possible that the allocation made by one person would never match that made by another." *Ramsey Accessories Mfg. Corp.* v. *Commissioner,* 10 T.C. 482, 489. See *Eitel-McCullough, Inc.* v. *Commissioner,* 9 T.C. 1132; *Keystone Brass Works* v. *Commissioner,* 12 T.C. 618; *Pantasote Leather Co.* v. *Commissioner, supra.*

As a result of such problems of apportionment and proof, many taxpayers who made claims with respect to newly developed products only under Section 721

(a)(2)(C) were granted no relief.[45] See *Eitel-McCullough, Inc.* v. *Commissioner, supra; Keystone Macaroni Manufacturing Co.* v. *Commissioner,* 18 T.C. 1078; *E. W. Williams Publications, Inc.* v. *Commissioner,* 25 T.C. 282. See, also, *L. E. Carpenter & Co.* v. *Commissioner,* 29 T.C. 562, review dismissed for lack of jurisdiction, 264 F. 2d 230 (C.A. 3d), where relief under Section 721(a)(2)(C) was denied because of the taxpayer's failure to establish that profits resulted from research rather than mere mechanical modifications of machinery for use in known processes. Other taxpayers, having shown that they were entitled to something (see *Cohan* v. *Commissioner,* 39 F. 2d 540 (C.A. 2d)), received only a portion of the relief claimed under Section 721. See *Rochester Button Co.* v. *Commissioner, supra; Ramsey Accessories Mfg. Corp.* v. *Commissioner, supra; Keystone Brass Works* v. *Commissioner, supra; Pantasote Leather Co.* v. *Commissioner, supra.* Despite the overlapping of the provisions of Sections 721 and 722, most taxpayers apparently reached the conclusion that since both sections involved the risks of submitting to discretionary administrative determinations, it was to their advantage to seek the greater relief possible under Section 722[46]—and by 1950,

[45] Problems of apportionment did not impede relief under Section 721(a)(2)(C) with respect to income from "exploration, discovery [or] prospecting" in the mining industries. See *Richey* v. *Commissioner,* 19 T.C. 926.

[46] See Bulletin on Section 722, *supra,* pp. 50–52, 116–117, with respect to relief for taxpayers introducing new products. See, also, *Avey Drilling Machine Co.* v. *Commissioner,* 16 T.C. 1281; *Morgan Construction Co.* v. *Commissioner,* 23 T.C. 242; and cf. *Don Baxter, Inc.* v. *Commissioner, supra.*

more than 19,000 corporations had instituted 54,000 cases under Section 722. See House Hearings, Excess Profits Tax Act of 1950, p. 47.

In summary, it is apparent that the two principal relief provisions of the Second World War excess profits tax law (Sections 721 and 722) were closely correlated, had overlapping functions, and in practical application vested a great amount of discretion in the Commissioner, with review only by the Tax Court. That was in accordance with the basic design of the law, expressed as follows in the House Ways and Means Committee Report on the Excess Profits Tax Amendments of 1941 (H. Rep. No. 146, 77th Cong., 1st Sess., p. 2 (1941–1 Cum. Bull. 550–551)):

> Experience with excess-profits taxes, both in the United States and abroad, has demonstrated conclusively that relief in abnormal cases cannot be predicated on specific instances foreseeable at any time. The unusual cases that are certain to arise are so diverse in character and unpredictable that relief provisions couched in other than general and flexible terms are certain to prove inadequate.
>
> For these reasons, the present legislation attempts to provide, both by specific terms and in carefully guarded general terms, a set of flexible rules which should alleviate at least the bulk of the severe hardship cases which may arise.

2. The terms "exploration", "discovery", and "prospecting" were used to provide special treatment, as abnormal income, for income derived from the oil, gas and other natural resources industries.

In Section 721(a)(2)(C), the World War II statute provided relief for a class of abnormal income, including "Income resulting from *exploration, discovery, prospecting* * * * or any combination of the foregoing, extending over a period of more than 12 months * * *." (Emphasis added.) The income granted relief by the quoted provision was income from the same natural resources which had been found, after extended hearings, entitled to special treatment in Section 337 of the excess profits tax title of the Revenue Acts of 1918 and 1921, *supra*. The very terms emphasized above are the same as those previously used in excess profits tax and income tax laws to deal specially with income from natural resources. See 1939 Code Sections 105 and 114(b)(2) and the history of those sections since 1918, *supra*. As always in the past, the words "exploration," "discovery," and "prospecting" in the tax law had reference only to the oil, gas and other natural resources industries and were employed for the purpose of providing special relief treatment for income derived from "discovery" in those industries only.[47] In-

[47] As indicated, *supra*, Section 721(a)(2)(C) was integrated within the pattern of Sections 721 and 722 and of the statute as a whole, which provided general discretionary relief for a wide variety of situations and taxpayers. Even Section 721(a)(2)(C) itself contained provisions for relief of income from "research, or development of tangible property, patents, formulae, or processes." See the provisions of Section 721(a)(2) quoted in full in the Appendix, *infra*, pp. 37a–38a.

deed, in conference, Section 721(a)(2)(C) was rewritten so that its language would conform to provisions relating to income from discovery in the oil, gas and mining industries appearing elsewhere in the Code. Sections 105 and 114(b)(2), *supra*.[48]

At the hearings concerning the proposed excess profits tax, representatives of the oil, gas and natural resources industries presented extensive testimony concerning the need for favorable tax treatment of income from *exploration, discovery* and *prospecting* in these industries. Thus, there was extensive testimony as to the hazards of exploration and prospect-

[48] As originally written, subsection (a)(2)(C) provided relief as follows (H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 50 (1940-2 Cum. Bull. 548, 556)):

> (3) Income resulting from the exploration, discovery, prospecting, research, or development of tangible property, patents, formulas, or processes, or any combination thereof, by the taxpayer or any of its predecessors, providing that such exploration, etc., extended over a period of more than 1 year * * *.

In Conference, the subsection was rewritten to provide that (H. Conference Rep. No. 3002, *supra*, p. 51 (1940-2 Cum. Bull. 548, 556)):

> The exploration, etc., from which the income is derived must be the taxpayer's own exploration. Income resulting from activities of such a character carried on by a predecessor corporation is not entitled to the treatment provided in section 721.

The change increased the similarity of the wording to that employed with respect to income from discovery in the oil, gas and mining industries in Sections 105 and 114(b)(2) of the Code, *supra*.

Separate provisions according to taxpayers generally the benefit of the experience of predecessor corporations, and the like, were contained in Supplement A of the law, Sections 740 and 742 of the Code.

ing, the dependence of the mineral developing industries on continued new *discoveries,* and the need for tax relief to furnish incentive to encourage "wildcatters" and prospectors to take risks in the search for mineral discoveries. Joint Hearings on Excess Profits Taxation, August, 1940, pp. 224–227; Senate Hearings on the Second Revenue Act of 1940, pp. 217–218, 328–329, 373–374. To conform with the relief afforded them under the income tax laws and prior excess profits tax statutes, representatives of natural resources companies urged that "the special relief provision should be considerably broadened, probably under provisions similar to those of prior acts", and should be administered by a special, independent board. Joint Hearings, *supra,* pp. 285–286; Senate Hearings, *supra,* p. 285. They specifically recommended that (Senate Hearings, *supra,* p. 374):

> There should be provided a deficiency carry-over or the excess tax should be levied on the average income of several years. That is because * * * this mining business is an up-and-down business * * *."

On the floor of the Senate, the subsection in question was discussed in terms of the oil, gas and mining industries. See 86 Cong. Rec. 12174–12177, 12919.[49]

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[49] Compare the similar suggestion made in connection with the excess profits tax provisions of the Revenue Act of 1918, *supra.*

[50] The following example was presented by Senator King of Utah as illustrative of the operation of the subsection in the case of a mineral discovery (86 Cong. Rec. 12177):

> * * * if a mining corporation has been working for a num-

The relief granted the natural resources industries by Section 721(a)(2)(C) constituted only one aspect of the special treatment accorded those industries. Special treatment is also made available in the section dealing with adjustments to be made to normal tax net income in the computation of excess profits net income. Section 711(a)(1)(I), (a)(2)(K), and (b)(1)(I). In the case of corporations engaged in the mining of certain strategic minerals, Section 731 provided for the exemption from the excess profits tax of "the portion of the adjusted excess profits net income attributable to such mining in the United States". Section 735 contained special provisions relating to "Nontaxable Income from Certain Mining and Timber Operations, and from Natural Gas Properties". That section—commonly referred to as the "exempt excess output" provision—granted exemption from the excess profits tax for income derived from exceptionally high output of depletable resources and, at the option of the taxpayer, also granted exemption for bonus payments made by the Government to encourage such production. See also Section 722(f). The purpose of these sections was to encourage exploration and prospecting, to achieve the discovery of new mineral resources and increased

ber of years—say, 10 years—and a windfall comes on the tenth year, there would be no exception with respect to the normal income tax, but, for the purposes of the excess-profits tax, the amount would be considered to cover 5 years, and the windfall would be allocated to a number of years rather than to the year in which it was paid.

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production from old mines deemed particularly essential to the national defense. See S. Rep. No. 673, Part 1, 77th Cong., 1st Sess., pp. 13–14 (1941–2 Cum. Bull. 466, 477–478); H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 27, 149 (1942–2 Cum. Bull. 372, 394–395, 482); S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 38–40, 186–188, 205, 207, 211 (1942–2 Cum. Bull. 504, 536–538, 641–643, 654, 656, 658–659). These sections were coordinated with and designed to provide a solution to the same problems of the natural resources industries as was the portion of Section 721(a)(2)(C), *supra,* relating to income from "exploration, discovery, prospecting".

Sections 105 and 114(b)(2) of the income tax chapter of the 1939 Code, in effect throughout the period covered by the Second World War excess profits tax law, also provided special treatment for income from natural resources. Section 105 is the provision limiting to 30 percent the tax on income from sale of oil or gas properties "where the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the taxpayer". As we have shown, that provision had been added to the tax law in connection with the World War I excess profits tax (Revenue Act of 1918, *supra,* Sections 211(b) and 337) and, with only a brief interruption, has been retained continuously since then. Section 114(b)(2) provided for depletion on the basis of "discovery value" in the case of mines.[51] This section also

[51] The percentage depletion provisions, greatly expanded, were carried into the 1939 Code in Section 114(b) (3) and (4).

has been traced, *supra*, to the Revenue Act of 1918 (Sections 214(a)(10), 234(a)(9), *supra*).

Section 728 of the World War II excess profits tax law (Subchapter E of Chapter 2 of the Code) stated:

> The terms used in this subchapter [Subchapter E] shall have the same meaning as when used in Chapter 1 [the income tax chapter].

Accordingly, the terms "exploration", "discovery", and "prospecting", which in the cited income tax sections have always referred exclusively to the oil, gas, mining and other natural resources industries, necessarily had the same meaning in Section 721(a)(2)(C).

D. *During the Korean War period, the statute (Section 456) provided excess profits tax relief as to income resulting from exploration, discovery or prospecting with reference only to the natural resources industries—and by separate sections provided relief with respect to income derived from new products, industrial expansion and other sources*

1. The general pattern of the Korean War excess profits tax law, and its relief provisions

The 1950 or Korean War excess profits tax law was added as Subchapter D to Chapter 1 of the Code by Section 101 of the Excess Profits Tax Act of 1950, *supra*. This law was patterned in large measure upon the World War II law. Although the general scheme of this 1950 law was derived substantially from earlier statutes, much of the philosophy and many of the particular provisions of the 1950 statute reflected substantial departures from the prior law.

In the new Subchapter D, a tax was imposed by Section 430(a)(1) upon the "adjusted excess profits net income", as defined in Section 431, of every cor-

poration. This "adjusted excess profits net income" was computed by taking the "excess profits net income"—which, under Section 433 (Appendix, *infra*, pp. 5a–7a), was the "normal-tax net income" as defined in Section 13(a)(2), increased or decreased by certain adjustments—and subtracting therefrom either the total of (1) an excess profits credit, allowed under Section 434, and (2) an unused excess profits credit adjustment computed under Section 432, or a minimum of $25,000. The "excess profits credit" allowed under Section 434 (Appendix, *infra*, p. 8a) was computed under Section 435 (Appendix, *infra*, pp. 8a–13a) on the basis of average net income during the so-called "base period", generally the years 1946 through 1949, or under Section 436 upon the basis of invested capital, whichever resulted in the lesser tax. Thus the Korean War law, viewed broadly, also taxed all profits above a certain level or norm, called the "excess profits credit" and computed on the basis of average income or invested capital. See Sections 436 through 441 setting forth the detailed rules for the credit on the invested capital method.

The so-called "two-basket" approach of the World War II law, which had caused many administrative difficulties, was intentionally discarded. See H. Rep. No. 3142, 81st Cong., 2d Sess., p. 4 (1951–1 Cum. Bull. 187, 189), and S. Rep. No. 2679, 81st Cong., 2d Sess., pp. 4–5 (1951–1 Cum. Bull. 240, 242–243). Under the World War II system (as finally amended, effective beginning with the year 1942), the corporate income tax was imposed only on income not subjected to the excess profits tax. See *Ambassador Hotel Co.*

*of Los Angeles* v. *Commissioner*, 280 F. 2d 303, 305 (C.A. 9th), petition for certiorari filed on October 26, 1960 (No. 509, this Term). In the 1950 law, the income tax was imposed on the entire amount of taxable net income; the excess profits tax was an additional tax imposed on the "adjusted excess profits net income", computed generally as outlined above.

Apart from this structural change, one of the most significant areas of departure was in the so-called "relief" provisions—particularly, with reference to the grant of relief in those categories which had been covered in the World War II law under the "general relief" provisions of Section 722 (Appendix, *infra*, pp. 41a–44a).[52]

Although the Korean War law made several major changes with respect to the grounds upon which relief had been authorized under Section 722 of the earlier law—*i.e.*, with respect to the particular "abnormalities", conditions, or events, etc., prescribed for establishing *qualification* for relief under the statute—the change which was by far the most important was the

[52] Besides Section 722, relief under the World War II law was also granted, as we have seen, by the other two "abnormalities" provisions, namely, some parts of Section 711(b)(1) and Section 721. As to all three, a review of the Commissioner's determination was authorized only in the Tax Court, and, further, in the case of Section 722 and Section 721(a)(2)(C)—the antecedent of Section 456(a)(2)(B) directly involved here—by the Special Division of the Tax Court pursuant to Section 732(d). Any further review (in the appellate courts) was specifically prohibited by Section 732(c) of the Code. No comparable prohibition was contained in the Korean War law, and hence relief determinations under it are fully reviewable in the courts, to the same extent as determinations on other questions.

abandonment of the requirement of the prior law that a qualifying taxpayer must also establish "a fair and just amount representing normal earnings" (Section 722(a)), to be used as a "constructive average base period net income" (CABPNI) in all cases under the "general relief" provisions of Section 722. Congress concluded that the requirement under the former law of a hypothetical or constructive base period income (CABPNI), to be "tailor made" for each qualifying taxpayer, was too burdensome and difficult of proof,[53] and had been generally unsatisfactory in

[53] In referring to the problems in establishing a constructive average base period net income under Section 722, Congress observed, among other things (S. Rep. No. 2679, *supra*, p. 17 (1951-1 Cum. Bull., at p. 252)):

> Each case was a problem in research, and the legal or tax result generally was intertwined with complicated accounting and economic problems. Almost every factor which had any influence on the particular business was pertinent to the case and the time and expense involved in reconstructing the average base period earnings credit were tremendous.

See also, to the same effect, H. Rep. No. 3142, *supra*, p. 16 (1951-1 Cum. Bull., at p. 197).

The Sixth Circuit, declining to review in *Patent Button Co. of Tenn.* v. *Commissioner*, 256 F. 2d 726, stated with respect to the World War II relief provisions (p. 728):

> The concept that granting tax relief because of abnormal conditions requires expert judgment upon factors "not entirely susceptible of proof or disproof" and, so, negates the authority of a court to redetermine by review the judgment of an expert * * * has been recognized * * *.

Similarly, the Fourth Circuit in *St. [illegible]a Hosiery Mills* v. *Commissioner*, 249 F. 2d 469, stated (p. 471):

> The questions involved in such cases are complicated and highly technical; and the manifest purpose of Congress was to allow review of the Commissioner's action only by an administrative court having special competence in the premises.

practice. See H. Rep. No. 3142, *supra*, pp. 15–16 (1951–1 Cum. Bull., at p. 197); S. Rep. No. 2679, *supra*, pp. 17–18 (1951–1 Cum. Bull., at pp. 251–252). Congress therefore saw fit to substitute, in the Korean War law, a measure of relief based upon the automatic application of specific mathematical formulas. Thus, instead of the CABPNI of the former law, with all its complexities and discretionary factors, Congress adopted relief provisions in terms of specific formulae, measured with reference to the base period rates of return for the taxpayer's industry classification, which rates were to be determined and proclaimed by the Commissioner pursuant to Section 447 of the new law (Appendix, *infra*, pp. 19a–21a).[54]

As the result of that change in the basic concept governing the computation of the relief accorded to taxpayers establishing qualification or eligibility for relief—and, further, because of the adoption in the Korean War law of various other adjustments designed to alleviate the burden of the tax (see H. Rep. No. 3142, *supra*, at pp. 15–25 (1951–1 Cum. Bull., at pp. 197–204) and S. Rep. No. 2679, *supra*, pp. 17–29 (1951–1 Cum. Bull., at pp. 251–259))—Congress deemed it appropriate to modify or curtail the respective grounds for relief previously authorized under Section 722. For these same reasons, Congress also restricted the relief previously granted under Section

[54] In *Burford-Toothaker Tractor Co.* v. *United States*, 262 F. 2d 891, 892–893, the Fifth Circuit referred to "the metaphysical subjective imponderables in old Section 722 which Congress rejected as unworkable and unfair" when it prescribed an "automatic objective formula" for the Korean War law.

721 so as to eliminate the one phase which would have required the retention of the discretionary approach (see H. Rep. No. 3142, *supra,* p. 13 (1951–1 Cum. Bull., at p. 195); and S. Rep. No. 2679, *supra,* p. 13 (1951–1 Cum. Bull., at p. 249))—namely, that portion of Section 721(a)(2)(C) which had granted relief as to income "resulting from * * * research, or development of tangible property, patents, formulae, or processes * * *." In net effect, the various situations for which relief had been provided under Sections 721 and 722 of the prior law were either included within "automatic" relief provisions or they were eliminated.

Thus, the authorization for relief under Section 722(b)(1) with respect to decreased base period production or operation as the result of unusual or peculiar events found its way into a comparable provision in the Korean War law (Section 442(a)(1)). The relief formerly authorized in Section 722(b)(2) for the case of a taxpayer whose base period business was depressed by reason of temporary economic circumstances unusual in its experience was similarly authorized, with some limitation, by Section 442(a)(2).[55] The provisions which had authorized

[55] It may be noted that Section 722(b)(2) had also authorized relief where the business of the taxpayer during the base period was depressed because its industry was depressed by reason of temporary economic events unusual in that industry—which was eliminated as a ground for relief in the Korean War law because it was regarded as desirable to avoid the difficult questions of proof of depression in an industry as a whole, and because it was felt that hardship in such cases would be alleviated by other provisions being adopted in the Korean War law. H. Rep. No. 3142, *supra*, p. 17 (1951–1 Cum. Bull., at p. 198); S. Rep. No. 2679, *supra*, p. 19 (1951–1 Cum. Bull., at p. 252).

relief in the case of a taxpayer whose base period business was depressed as the result of either variant profit cycles or sporadic income (Section 722(b)(3)(A) and (B)) found their way into the provisions of Section 446 of the Korean War law, which granted a modified form of relief with respect to "depressed industry subgroups."

Subsection (b)(4) of Section 722 had provided relief for two classes of taxpayers, (1) those which commenced business and (2) those which changed the character of their business, either during or immediately prior to the base period. In the Korean War law, relief for the first class was provided by a separate provision (Section 445, Appendix, *infra*, p. 18a) which authorized the use by a "new corporation" (commencing business during or after the base period) of an alternative average base period net income computed upon the basis of the taxpayer's total assets and the base period rate of return for its industry classification (pursuant to Section 447).[56] Substantial and significant changes were made in the Korean War law with respect to the relief grounds authorized in the World War II law with respect to the second class, corporations which had undergone a change in the character of their business. In Section 722(b)(4), the term "change in the character of the business" had been defined as specifically including these categories: (a) "a change in the operation or management of the busi-

[56] The Korean War law provided a further measure of relief for new corporations by the reduced rates of tax authorized pursuant to Section 430(a)(3) and (e). (Appendix, *infra*, pp. 3a–4a).

ness"; (b) "a difference in the products or services furnished"; (c) "a difference in the capacity for production or operation"; (d) "a difference in the ratio of nonborrowed capital to total capital"; and (e) "the acquisition before January 1, 1940, of all or part of the assets of a competitor", eliminating or diminishing competition by that competitor. In the Korean War law, Congress deliberately eliminated as grounds for relief changes in management, changes in operation (*i.e.*, changes in *method* of operation), changes in the ratio of non-borrowed to total capital, and the acquisition of competitors; it regarded such grounds as either unimportant or insignificant, or unwarranted, or too difficult to apply. See H. Rep. No. 3142, *supra,* pp. 19–21 (1951–1 Cum. Bull., at pp. 199–201); S. Rep. No. 2679, *supra,* pp. 24–25 (1951–1 Cum. Bull., at pp. 256–257). Relief because of an increase in capacity was retained with some restrictions in Section 444 (Appendix, *infra,* p. 17a). Relief upon the basis of a "difference in the products or services furnished", which had existed under Section 722(b)(4) in the Second World War law, was again adopted as a ground for relief under the Korean War law (Section 443, Appendix, *infra,* pp. 14a–16a).

In Section 443 of the new law, Congress retained—but with new restrictions and limitations—the concept of the prior law that a change in products or services is an appropriate basis for relief, and specifically recognized that the experience under the World War II law with respect to that concept "was generally satisfactory". S. Rep. No. 2679, *supra,* p. 21 (1951–1 Cum. Bull., at p. 254). See also H. Rep. No. 3142,

*supra*, pp. 18–19, 54–55 (1951–1 Cum. Bull., at pp. 199–200, 225–226); H. Conference Rep. No. 3231, 81st Cong., 2d Sess., p. 21 (1951–1 Cum. Bull. 268, 274–275); and "Summary of * * * 'THE EXCESS PROFITS TAX ACT of 1950' as agreed to by the Conferees", prepared by the Staff of the Joint Committee on Internal Revenue Taxation (1951), pp. 13–14. The requirement of subsection (a)(1) that there be a "substantial change" in products or services does, it is true, leave room for a certain measure of discretion. However, qualification is largely governed by the requirements of subsections (a)(2) and (a)(3), respectively, that the new products or services account for over 40 per cent of gross income or 33 per cent of net income, and that there be an increase of more than 25 per cent in the excess profits net income. Furthermore, if qualification for relief is established by satisfying the qualifying tests of subsections (a)(1), (a)(2) and (a)(3), the amount of relief allowable is computed mathematically pursuant to subsection (b)(1) and (2), *i.e.*, by applying the base period rate of return for the taxpayer's industry classification under Section 447 to the taxpayer's total assets.

The benefits of all of these sections (Sections 442 through 446) were made available only upon application by the taxpayer pursuant to Section 447(e). And, in all cases under Sections 442 through 446, the amount of relief is computed by reference to specified mathematical formulae based upon the applicable industry base period rate of return proclaimed pursuant to Section 447.

The relief formerly allowable under Section 711(b)(1) (H), (I), (J), and (K), with respect to certain base period "abnormal" deductions, deductions attributable to a judgment or award, deductions attributable to intangible drilling costs, etc., for the purpose of the computation of the excess profits credit under the "income method," found its way (with some variations) into the Korean War law as an adjustment authorized to be made under Section 433(b)(9) (Appendix, *infra*, p. 7a) and (10).

Relief substantially similar to that formerly allowed as an automatic adjustment under the "75% rule" of Section 713(e) was again allowed in the Korean War law, though somewhat amplified and liberalized, under the provisions of Section 435(d) (Appendix, *infra*, pp. 9a–10a), permitting the elimination of the taxpayer's poorest base period year and the treatment of any deficit base period year as a "zero" year. See H. Rep. No. 3142, *supra*, p. 5 (1951–1 Cum. Bull., at p. 190). The other World War II automatic computation adjustment was by means of the so-called "growth formula" computation under Section 713(f). In the Korean War law, the "growth" concept was given some recognition in the provisions of Section 435(e) (Appendix, *infra*, pp. 10a–13a), which authorized an *alternative* average base period net income to be used in "growth" cases, but subject to greater restrictions and limitations—as, for example, the requirement contained in Section 435(e)(1)(B)(ii) that a minimum percentage of the taxpayer's sales be "attributable to a product, or class of products * * *, of a kind not generally available to the public" before the base period (*i.e.*, prior to 1946. See H. Rep. No. 3142, *supra*, pp. 23–

24 (1951-1 Cum. Bull., at p. 203), and S. Rep. No. 2679, *supra*, pp. 26–28 (1951-1 Cum. Bull., at pp. 251–259).

Viewing Section 435(e) together with Sections 443 and 444, it is apparent that by those provisions the Korean War law made available automatic relief adequate for manufacturers who, like the taxpayer here, experienced growth, introduced new products, or increased productive capacity during or shortly after the base period. Congress must have contemplated that manufacturers like this taxpayer look to the area of those provisions for their relief—and not to Section 456.

2. In Section 456(a)(2)(B) of the Korean War excess profits tax law, relief for income from the sale of products of "research" and "development," allowed under the prior law, was deliberately omitted and relief was provided only for income from "exploration, discovery, or prospecting" in the natural resources industries

As we have seen, *supra*, pp. 12–13, 16–17, 59–60, Section 456 of the 1950 Act was analogous to Section 721 of the World War II law, and similarly provided relief with respect to certain abnormal income received during the taxable year by permitting its reallocation to other years. But, in accordance with the changed concept of relief under the 1950 Act, the applicability of Section 456 was limited to four classes of income easily identified as to character and reasonably ascertainable as to amount. One of these classes—the one relied upon by the taxpayer here—is Section 456(a)(2)(B):

> (B) Income resulting from exploration, discovery, or prospecting, or any combination of

> the foregoing, extending over a period of more than 12 months * * *.

It was explained in both pertinent Committee Reports (H. Rep. No. 3142, 81st Cong., 2d Sess., p. 13 (1951–1 Cum. Bull. 187, 195); S. Rep. No. 2679, 81st Cong., 2d Sess., p. 14 (1951–1 Cum. Bull. 240, 249)) that:

> The equivalent provision in the World War II law (section 721) also permitted adjustments with reference to certain other types of income, particularly that resulting from the sale of tangible property arising out of research and development which extended over a period of more than 12 months.

However, in view of the automatic relief concept adopted in the 1950 Act, that additional feature of the old law—which was regarded (*ibid.*) as representing "a potential loophole of major dimensions"—was omitted from the classes of abnormal income for which relief was provided in the 1950 law.[57] The omission was made, it was explained (*ibid.*) "[b]ecause there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (section 722) * * *". See *Polaroid Corp.* v. *Commissioner, supra,* 278 F. 2d at 155, where the First Circuit, discussing this legislative history, concluded: "Thus even 'meritorious cases' that would have come under this now excluded phrase ["research, or development

[57] See *Specialties, Inc.* v. *United States*, 174 F. Supp. 89, 93 (E.D. N.Y.), to the effect that the Committee Reports "both state in parallel language that this omission was intentional".

of tangible property"] were deliberately sacrificed in the interest of administrative simplification."[58]

In accordance with the concept of relief under the 1950 Act, the much broader class granted relief under the former Section 721(a)(2)(C) was confined by the new Section 456(a)(2)(B) so as to cover only income resulting from "exploration, discovery, or prospecting." Those terms, as we have seen, have long had an established meaning in the tax law limited to the natural resource industries, in which area the concept of "discovery value" had evolved (see Rev. Rul. 236, 1953–2 Cum. Bull. 236). Congress was aware, as observed above, that it had been found extremely difficult to ascertain what income was derived from "research" or "development" of tangible property, patents,[59] formulae or processes (see H. Rep. No. 3142, *supra*, p. 13 (1951–1 Cum. Bull. 187, 195); S. Rep. No. 2679, *supra*, p. 14 (1951–1 Cum. Bull. 240, 249)).

The taxpayer has urged (Br. in Op., pp. 6, 8) that, even though income of the type here involved has

[58] The loophole under the Second World War law was presumably regarded as "potential" rather than actual, because grants of relief under Section 721 for abnormal income resulting from the "research, or development of tangible property, patents, formulae, or processes" had been reasonably restricted in the litigated cases. See, *e.g.*, *Crowell-Collier Publishing Co.* v. *Commissioner*, 25 T.C. 1268, review dismissed on this point for lack of jurisdiction, 259 F. 2d 860 (C.A. 2d), certiorari denied, 358 U.S. 928; *L. E. Carpenter & Co.* v. *Commissioner*, 29 T.C. 562, review dismissed for lack of jurisdiction, 264 F. 2d 230 (C.A. 3d). See also the cases discussed *supra*, pp. 46–48. As we already have pointed out, because of Section 732(c) there was no appellate review of any question under the relief provisions of the Second World War law.

[59] See 10 Mertens, *Law of Federal Income Taxation* (Rev.), Sec. 59.38.

been excluded from the classes of income specifically listed in Section 456(a)(2), it is entitled to relief under the last sentence of Section 456(a)(2), which states:

> The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

It is apparent, however, that this provision merely grants the Secretary authority to designate such additional classes of abnormal income as he may consider appropriate, acting, of course, consistently with the Congressional purpose expressed in Section 456. Any other conclusion would require the totally illogical result that all income which is received in amounts sufficient to satisfy the quantitative requirements of Section 456(a)(1) would be entitled to relief as "abnormal income" under Section 456. As already demonstrated, the classes of income treated as "abnormal" under Section 456(a)(2) were severely restricted because Congress decided to depart from the broader criteria of Section 721(a)(1) and (2) of the World War II statute. This restriction would have been an idle gesture if it were to be ruled that income of *any* class must be considered "abnormal" if it meets the quantitative test. See *Polaroid Corp.* v. *Commissioner, supra,* 278 F. 2d at 155–156.

Moreover, the Treasury has prescribed Regulations which specifically exclude income, such as this taxpayer's, derived from research and development. See Treasury Regulations 130, Section 40.456–2 (Appendix, *infra,* pp. 46a–47a). These Regulations further state,

to be sure, that Section 456 is applicable to income from research and development if the income is otherwise properly includible within a class of income listed in the section, for example, the class described in Section 456(a)(2)(D) (relating to income resulting from a change in accounting methods). That provision of the Regulations means only that *if* income arising from research and development *otherwise* qualifies as abnormal under a class listed in Section 456(a)(2), then the fact that it does arise from research and development will not disqualify such income from relief. To cite another example, if a taxpayer were awarded a judgment during the excess profits tax years (see Section 456(a)(2)(A)), even though the judgment was based on infringement with respect to products arising out of research and development, the income from the judgment could still qualify as "abnormal." However, the taxpayer's income in issue in this case is not "otherwise" within any of the classes granted relief under Section 456 (or the implementing Regulations).[80]

As in the case of prior excess profits tax laws, the Congressional hearings disclose that the representatives of the natural resources industries sought special

[80] Any suggestion that the products and income here involved could meet the "geophysical test"—on the theory that the taxpayer could show that "the important starting chemical of each drug is derived from coal tar or petroleum" (Br. in Op., p. 14)—is far wide of the mark. In order to meet the test the statute imposes, the taxpayer would have to establish that its alleged abnormal income was income resulting from a discovery of coal tar or petroleum, *i.e.*, a discovery of *deposits* of *coal* or *petroleum*.

treatment,[61] especially of the type granted formerly under Section 721. In particular, the American Mining Congress urged (House Hearings, Excess Profits Tax Act of 1950, p. 172) that:[62]

> The principle of section 721 should be continued with such revisions as may be needed to remove some of the complications and difficulties now encountered and to make it more directly and fully effective.

The representative of the same organization pointed out that in the case of a mine the profit potential is readily ascertainable and that reliable expert judgments may be utilized in the computation of excess profits.[63] See Rev. Rul. 236, 1953–2 Cum. Bull. 236.

The 1950 Act provided further substantial relief in recognition of the peculiar problems of the natural resources industries. In particular, the non-taxable income from the exempt excess output of taxpayers engaged in certain depletable resources industries (Section 453, Appendix, *infra,* pp. 21a–24a) was excluded from the computation of excess profits net income (Section 433(a)(1)(I)) (Appendix, *infra,* pp. 5a–

[61] See House Hearings, Excess Profits Tax Act of 1950, pp. 164–192; Senate Hearings, Excess Profits Tax Act of 1950, pp. 715–728, 777–781.

[62] See also House Hearings, *supra*, pp. 170–171.

[63] House Hearings, *supra*, pp. 169–170:

> The nature of the determinations required with respect to a reasonable normal profit per unit or reasonable normal expectancy is well understood by experienced mining engineers. They are continually making such determinations in their professional work. * * * Hence the adoption of such constructive determinations in connection with taxation is not going into a new and untried field. It is a part of the ordinary knowledge, experience, and training of mining engineers.

6a). The amount of the exempt excess output was computed under Section 453 on the basis of "estimated recoverable units" and "normal output" for particular mineral properties, since such estimates could be made with reasonable accuracy in the mining industries. See footnote 63, *supra*. Further, certain grants and loans made by the Federal Government and its agencies to encourage exploration, development or mining of critical and strategic minerals and metals were similarly excluded. Section 433(a)(1)(P) (Appendix, *infra*, p. 6a). Also, the portion of excess profits net income attributable to the mining of strategic minerals in the United States was wholly exempted from the excess profits tax. Section 450 (Appendix, *infra*, p. 21a).

Special treatment for natural resources industries was retained and expanded in the income tax sections of the Code in effect at the same time as the 1950 excess profits tax law.[64] The long-established provisions of Sections 105[65] and 114(b)(2),[66] for the relief of taxpayers having income derived from the discovery values of natural resources, were continued. In addition, Section 23(ff)—added by Section 342(a), Revenue Act of 1951, c. 521, 65 Stat. 452—permitted the deduction from net income of certain "exploration expenditures", including:

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[64] Contrast the relief for income of individuals and partnerships, but not corporations, derived from inventions, provided by Section 107(b) of the Code.

[65] Limiting the tax on income from the sale of oil or gas properties or interests "where the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the taxpayer * * *".

[66] Providing for depletion on the basis of discovery value in the case of certain mines.

> In the case of expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, and paid or incurred prior to the beginning of the development stage of the mine or deposit, so much of such expenditures as does not exceed $75,000. * * *

The concepts of "exploration" and "discovery" appear in Section 23(ff)(2) in connection with the option given to taxpayers to defer such expenses and deduct them ratably "as the units of produced ores or minerals discovered or explored by reason of such expenditures are sold".

The related portions of the Code, as well as the Congressional Hearings and Committee Reports discussed *supra,* demonstrate conclusively, we believe, that the provision of Section 456(a)(2)(B) granting relief for income resulting from "exploration, discovery, or prospecting" constitutes a part of the general scheme of income tax and excess profits tax relief for the natural resources industries and that the application of Section 456(a)(2)(B) is confined to these industries.[67]

The omission of the phrase "research, or development of tangible property, patents, formulae, or proc-

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[67] We do not discuss the wisdom of the "statutory policy", the sole problem here being the "application of the congressional mandate." Cf. *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81.

It may be noted in passing that the Court there (p. 81) referred to "mineral depletion for tax purposes" as an allowance to encourage "extensive *exploration* and increasing *discoveries* of additional minerals." (Emphasis supplied.)

esses" from Section 456(a)(2)(B) must be evaluated in the light of the history of the excess profits tax, particularly the relief provisions dealing with the natural resources industries and the gradual progression from discretionary relief administered by the Commissioner, to relief in his discretion but with review by the Tax Court, to automatic and readily ascertainable relief under the formulae of the Korean War law. Considered against the background of the discretionary relief provisions of prior excess profits tax statutes and the difficult problems encountered thereunder, the Congressional explanation of the omission of the "research" and "development" clause of the prior law leaves no doubt but that Section 456(a)(2)(B) was intended to provide relief *only* for the natural resources industries and that income from sales of products of research and development, such as the taxpayer's drugs, was deliberately excluded from relief under Section 456. When read in this light, the pertinent legislative explanation acquires, we submit, compelling force (H. Rep. No. 3142, 81st Cong., 2d Sess., p. 13 (1951–1 Cum. Bull. 187, 195); S. Rep. No. 2679, 81st Cong., 2d Sess., p. 13 (1951–1 Cum. Bull. 240, 249)):

> The bill contains a provision allowing the correction of the net income of the excess profits tax years for other abnormalities. This provision is similar to section 721 of the World War II law. Generally, income appearing in particular excess profits tax years is reallocated under this provision if it is attributable to events that occurred or work that was done in other years. Such an adjustment is made only

if the income of the class deemed to be abnormal received in the taxable year is more than 115 percent of the average amount of the income of the same class received during the four previous taxable years. In appropriate cases such an excess will be attributed to other years under regulations to be prescribed by the Secretary of the Treasury.

Adjustments of this type are limited to income arising out of—

1. A claim, award, adjustment, or decree;

2. Exploration, discovery, or prospecting which extended over a period of more than 12 months;

3. The sale of patents, formulas, or processes developed over a period of more than 12 months; or

4. Income which is includible in the taxable year rather than another year by reason of a change in the taxpayer's method of accounting.

The equivalent provision in the World War II law (section 721) also permitted adjustments with reference to certain other types of income, particularly that resulting from the sale of tangible property arising out of research and development which extended over a period of more than 12 months. This provision in the old law was a potential loophole of major dimensions. Because there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (section 722), and because the need for a reallocation of such income seemed to be materially less

than in the other classes of income described above, this item has been omitted from the list of abnormal types of income for which a reallocation can be made under this bill.

### CONCLUSION

For the reasons stated, the judgment of the Court of Appeals should be reversed, with directions to reinstate the judgment of the District Court dismissing the complaint.

Respectfully submitted.

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JANUARY 1961.

# APPENDIX

Internal Revenue Code of 1939:

## CHAPTER 1—INCOME TAX

* * * * *

### SUBCHAPTER C—SUPPLEMENTAL PROVISIONS

* * * * *

SEC. 105. SALE OF OIL OR GAS PROPERTIES.

In the case of a bona fide sale of any oil or gas property, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the taxpayer, the portion of the tax imposed by section 12 attributable to such sale shall not exceed 30 per centum of the selling price of such property or interest.

(26 U.S.C. 1952 ed., Sec. 105.)

SEC. 114 [as amended by Sec. 319(b), Revenue Act of 1951, c. 521, 65 Stat. 452]. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(2) *Discovery value in the case of mines.*—In the case of mines (except mines in respect of which percentage depletion is allowable under paragraph (4) of this subsection), discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of

purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance under section 23(m) based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist and if the discovered minerals are of sufficient value and quantity that they could separately mined and marketed at a profit.

* * * * *

(26 U.S.C. 1952 ed., Sec. 114.)

* * * * *

SUBCHAPTER D—EXCESS PROFITS TAX

[As added by Sec. 101, Excess Profits Tax Act of 1950, c. 1199, 64 Stat. 1137, Section 101.]

SEC. 430. IMPOSITION OF TAX.

(a) [as amended by Sec. 501(1), Revenue Act of 1951, *supra,* and the Act of July 16, 1953, c. 202, 67 Stat. 175] *General Rule.*—In addition to other taxes imposed by this chapter, there shall be levied, collected, and paid for each taxable year ending after June 30, 1950, and beginning before January 1, 1954, upon the adjusted excess profits net income, as defined in section 431, of every corporation (except a corporation exempt under section 454) an excess

profits tax equal to whichever of the following amounts is the lesser:

(1) 30 per centum of the adjusted excess profits net income, or

* * * * *

(3) in the case of a corporation for which an amount is determined for the taxable year under subsection (e), the amount determined under such subsection.

* * * * *

(e) [as added by Sec. 501(3), Revenue Act of 1951, *supra*] *New Corporations.*—

(1) *Alternative amount.*—In the case of a taxpayer which commenced business after July 1, 1945, and whose fifth taxable year ends after June 30, 1950, the amount referred to in subsection (a)(3) shall be—

(A) If the taxable year is the first or second taxable year of the taxpayer, an amount equal to 5 per centum of the excess profits net income for the taxable year, except that if the excess profits net income exceeds $300,000, the amount shall be the sum of $15,000 plus the amount determined under subparagraph (E) of this paragraph.

(B) If the taxable year is the third taxable year of the taxpayer, an amount equal to 8 per centum of the excess profits net income for the taxable year, except that if the excess profits net income exceeds $300,000, the amount shall be the sum of $24,000 plus the amount determined under subparagraph (E) of this paragraph.

(C) If the taxable year is the fourth taxable year of the taxpayer, an amount equal to 11 per centum of the excess profits net income for the taxable year, except that if the excess profits net income exceeds $300,000, the amount shall be the sum of

$33,000 plus the amount determined under subparagraph (E) of this paragraph.

(D) If the taxable year is the fifth taxable year of the taxpayer, an amount equal to 14 per centum of the excess profits net income for the taxable year, except that if the excess profits net income exceeds $300,000, the amount shall be the sum of $42,000 plus the amount determined under subparagraph (E) of this paragraph.

(E) The amount determined under this subparagraph shall be—

(i) if the taxable year ends before April 1, 1951, an amount equal to 15 per centum of the excess profits net income for the taxable year over $300,000.

(ii) if the taxable year begins on January 1, 1951, and ends on December 31, 1951, an amount equal to 17¼ per centum of the excess of the excess profits net income for the taxable year over $300,000.

(iii) if the taxable year (other than a taxable year described in clause (ii)) ends after March 31, 1951, an amount equal to 18 per centum of the excess of the excess profits net income for the taxable year over $300,000.

* * * * *

(f) [As amended by Sec. 501(2), Revenue Act of 1951, *supra*] *Cross References.*—For special rules for computation of the tax imposed by subsection (a) in the case of—

* * * * *

(2) corporations engaged in mining of strategic materials, see section 450(a);

(3) abnormalities in income in taxable period, see section 456;

* * * * *

(26 U.S.C. 1952 ed., Sec. 430.)

SEC. 431. DEFINITION OF ADJUSTED EXCESS PROFITS NET INCOME.

The term "adjusted excess profits net income" in the case of any taxable year means the excess profits net income (as defined in section 433(a)) minus the sum of:

(1) *Excess profits credit.*—The amount of the excess profits credit allowed under section 434; and

(2) *Unused excess profits credits.*—The amount of the unused excess profits credit adjustment for the taxable year computed in accordance with section 432.

If such sum is less than $25,000, it shall be increased to $25,000.

(26 U.S.C. 1952 ed., Sec. 431.)

SEC. 433. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Ending After June 30, 1950.*—The excess profits net income for any taxable year ending after June 30, 1950, shall be the normal-tax net income, as defined in section 13(a)(2), for such year increased or decreased by the following adjustments:

(1) *Adjustments.*—

* * * * *

(I) *Nontaxable income of certain industries with depletable resources.*—In the case of a producer of minerals, or a producer of logs or lumber from a timber block, or a lessor of mineral property, or a timber block, as defined in section 453, there shall be excluded nontaxable income from exempt excess output of mines and timber blocks provided in section 453; in the case of a natural gas company, as defined in section 453, there shall be excluded nontaxable income from exempt excess output provided in section 453; and in the case of a producer of minerals, or a producer of logs or lumber from a timber

block, there shall be excluded nontaxable bonus income provided in section 453. In respect of nontaxable bonus income provided in section 453(c), a corporation described in section 453(c)(2) shall be deemed a producer of minerals for the purposes of this subparagraph;

* * * * *

(P) *Payments to encourage exploration, development, and mining for defense purposes.*—An amount paid to a taxpayer by the United States (or any agency or instrumentality thereof), whether by grant or loan, and whether or not repayable, for the encouragement of exploration, development or mining of critical and strategic minerals or metals pursuant to or in connection with any undertaking approved by the United States (or any of its agencies or instrumentalities) and for which an accounting is made or required to be made to an appropriate governmental agency, and the forgiveness or discharge of any of such amount shall be excluded in computing excess profits net income; and any expenditures (other than expenditures made after the repayment of such grant or loan) attributable to such grant or loan shall not be deductible by the taxpayer as an expense nor increase the basis of the taxpayer's property either for determining gain or loss on sale, exchange, or other disposition or for computing depletion or depreciation, but upon the repayment of any portion of any such grant or loan which has been expended in accordance with the terms thereof such deductions and such increase in basis shall to the extent of such repayment be allowed as if made at the time of such repayment;

* * * * *

(b) *Taxable Years in Base Period.*—For the purposes of computing the average base period net income, the excess profits net income for any taxable year shall be the normal-tax net income, as defined in section 13(a)(2) as in effect for such taxable year, increased or decreased by the following adjustments:

* * * * *

(9) *Judgments, intangible drilling and development costs, casualty losses, and other abnormal deductions.*—If, for any taxable year or years within, or beginning or ending within, the base period, any class of deductions for the taxable year exceeded 115 per centum of the average amount of deductions of such class for the four previous taxable years (not including deductions arising from the same extraordinary event which gave rise to the deduction for the taxable year), the deductions of such class shall, subject to the rules provided in paragraph (10), be disallowed in an amount equal to such excess. For the purposes of this paragraph, each of the following groups of deductions shall constitute a class of deductions:

(A) Deductions attributable to claims, awards, judgments, and decrees against the taxpayer, and interest on the foregoing;

(B) Deductions attributable to intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, and for development costs in the case of mines; and

(C) Deductions under section 23(f) for losses arising from fires, storms, * * *

The classification of deductions of any class not described in subparagraphs (A) to (C), inclusive, shall be subject to regulations prescribed by the Secretary.

* * * * *

(26 U.S.C. 1952 ed., Sec. 433.)

SEC. 434. EXCESS PROFITS CREDIT—ALLOWANCE.

(a) *Domestic Corporations.*—In the case of a domestic corporation, the excess profits credit for any taxable year shall be an amount computed under section 435 or section 436, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 434.)

SEC. 435. EXCESS PROFITS CREDIT—BASED ON INCOME.

(a) [as amended by Sec. 602(a)(1), Revenue Act of 1951, *supra*] *Amount of Excess Profits Credit.*—The excess profits credit for any taxable year, computed under this section, shall be—

(1) *Domestic corporations.*—In the case of a domestic corporation the sum of—

(A) 83 per centum of the average base period net income,

(B) if the average base period net income of the taxpayer is the amount determined under subsection (d) of this section or under section 442, 12 per centum of the amount of the base period capital addition, computed under subsection (f), and

(C) 12 per centum of the net capital addition (as defined in subsection (g)(1)) for the taxable year, minus 12 per centum of the net capital reduction (as defined in subsection (g)(2)) for the taxable year.

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(b) *Base Period.*—As used in this subchapter the term "base period" means the period beginning January 1, 1946, and ending December 31, 1949, except that in the case of a taxpayer whose first taxable year under this subchapter was preceded by a taxable year which ended after December 31, 1949, and be-

fore April 1, 1950, and which began before January 1, 1950, the term "base period" means the period of 48 consecutive months ending with the close of such preceding taxable year.

(c) [as amended by Sec. 516(b), Revenue Act of 1951, *supra*] *Average Base Period Net Income—Determination.*—For the purposes of this section the average base period net income of the taxpayer shall be the amount determined under subsection (d), subject to the exception that if the taxpayer is entitled to the benefits of subsection (e) of this section, or section 442, 443, 444, 445 or 446, or any subsection of section 459, then the average base period net income shall be the amount determined under subsection (d) or (e) or under such section or subsection, whichever results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed.

(d) [as amended by Sec. 503, Revenue Act of 1951, *supra*] *Average Base Period Net Income—General Average.*—The average base period net income determined under this subsection shall be determined as follows:

(1) By computing the excess profits net income for each month in the base period. * * *

(2) By eliminating from the base period whichever of the following twelve months results in the higher average base period net income—

* * * * *

(3) By computing the aggregate of the excess profits net income for each of the thirty-six months remaining in the base period.

(4) By dividing by 3 the amount ascertained under paragraph (3).

For the purpose of the computations under this subsection in the case of a taxpayer whose

first taxable year under this subchapter is a taxable year which either began before January 1, 1950, or was preceded by a taxable year beginning before January 1, 1950, and ending after March 31, 1950, there shall be substituted for the base period of the taxpayer the period of 48 consecutive months ending March 31, 1950, if such substitution produces a lesser tax under this subchapter for the taxable year for which the tax is being computed. In computing the average base period net income for such substituted period, the excess profits net income for January, February, and March of 1950 shall be computed by use of the "weighted excess profits net income", as defined in section 435(e)(2)(E), for the taxable year in which such months fall.

(e) *Average Base Period Net Income—Alternative Based on Growth.*—

(1) [as amended by Sec. 504(a), Revenue Act of 1951, *supra*] *Taxpayers to which subsection applies.*—A taxpayer shall be entitled to the benefits of this subsection if the taxpayer commenced business before the end of its base period, and if either—

(A) (i) the total assets of the taxpayer as of the first day of its base period (when added to the total assets for such day of all corporations with which the taxpayer has the privilege under section 141 of filing a consolidated return for its first taxable year under this subchapter), determined under paragraph (3), did not exceed $20,000,000, and

(ii) The total payroll of the taxpayer (as determined under paragraph (4)) for the last half of its base period is 130 per centum or more of its total payroll for the first half of its base period, or the gross receipts of the taxpayer (as determined under paragraph (5)) for the last

half of its base period is 150 per centum or more of its gross receipts for the first half of its base period; or

(B)(i) the taxpayer's net sales for the period beginning January 1, 1950, and ending June 30, 1950, when multiplied by 2, equals or exceeds 150 per centum of its average net sales for the calendar years 1946–1947; and

(ii) 40 per centum or more of the taxpayer's net sales for the calendar year 1950 is attributable to a product, or class of products (including any article in which such product or class of products is the principal component and including any article which is a component of such product or class of products), of a kind not generally available to the public at any time prior to January 1, 1946, and

(iii) the amount of the taxpayer's net sales which is attributable to such product or class of similar products, for the calendar year 1946 is 5 per centum or less of the amount of its net sales so attributable for the calendar year 1949. For the purposes of this subparagraph, the term "net sales" with respect to any period means the total amount received or accrued during such period from the sale, exchange, or other disposition of stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; reduced by the amount of discounts, returns, and allowances paid or incurred for such period.

(2) [as amended by Sec. 505, Revenue Act of 1951, *supra*] *Computation.*—The aver-

age base period net income determined under this subsection shall be determined as follows:

(A) By computing (in the manner provided by the second sentence of subsection (d)(1)) the excess profits net income for each of the last 24 months in the base period.

(B) By computing the aggregate of the excess profits net income for each such month.

(C) By dividing by 2 the amount ascertained under subparagraph (B).

(D) By computing the aggregate of the excess profits net income for each of the last twelve months in the base period.

(E) By computing (in the manner provided by the second sentence of subsection (d)(1)) the excess profits net income for each of the twelve months in the period beginning July 1, 1949, and ending June 30, 1950. * * *

(F) By computing the aggregate of the excess profits net income for each of the twelve months referred to in subparagraph (E).

(G) In the case of a taxpayer who is entitled to the benefits of this subsection under paragraph (1)(B) and whose excess profits net income for the calendar year 1949 is not more than 25 per centum of its excess profits net income for the calendar year 1948, by computing—

(i) in the manner provided by subparagraph (E), the excess profits net income for each of the six months in the period beginning July 1, 1948, and ending December 31, 1948, and for each of the six months in the period beginning January 1, 1950, and [ending] June 30, 1950, and

(ii) the aggregate of the excess profits net income for each of the twelve months referred to in clause (i).

The average base period net income determined under this subsection shall be the amount ascertained under subparagraph (C), (D), or (F), whichever is the highest, except that in the case of a taxpayer described in subparagraph (G), its average base period net income determined under this subsection shall be the amount ascertained under subparagraph (C), (D), (F), or (G)(ii), whichever is the highest.

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(26 U.S.C. 1952 ed., Sec. 435.)

SEC. 442. AVERAGE BASE PERIOD NET INCOME—ABNORMALTIES DURING BASE PERIOD.

(a) [as amended by Sec. 509(a)(1), Revenue Act of 1951, *supra*] *In General.*—If a taxpayer which commenced business on or before the first day of its base period establishes that, for any taxable year within, or beginning or ending within, its base period:

(1) normal production, output, or operation was interrupted or diminished because of the occurrence, either immediately prior to, or during such taxable year, of events unusual and peculiar in the experience of such taxpayer, or

(2) the business of the taxpayer was depressed because of temporary economic circumstances unusual in the case of such taxpayer:

the taxpayer's average base period net income determined under this section shall be the amount computed under subsection (c) or (d), whichever is applicable. If such taxpayer is also entitled to the benefits of subsection (h), the taxpayer's average base period net income determined under this section shall be the amount computed under subsection (c) or (d),

whichever is applicable to the taxpayer, or the amount computed under subsection (h), whichever results in the lesser tax under this subchapter for the taxable year. In the case of any other taxpayer entitled to the benefits of subsection (h), the taxpayer's average base period net income determined under this section shall be the amount computed under subsection (h).

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(26 U.S.C. 1952 ed., Sec. 442.)

SEC. 443. AVERAGE BASE PERIOD NET INCOME—CHANGE IN PRODUCTS OR SERVICES.

(a) *In General.*—If a taxpayer which commenced business on or before the first day of its base period establishes with respect to any taxable year that—

(1) During so much of its three immediately preceding taxable years as falls within the 36-month period ending on the last day of its base period, there was a substantial change in the products or services furnished by the taxpayer.

(2) More than 40 per centum of its gross income or 33 per centum of its net income for such taxable year is attributable to one or more of the new products or services, and

(3) Its average monthly excess profits net income (determined under subsection (e)) for such taxable year exceeds 125 per centum of its average monthly excess profits net income (determined under subsection (e)) for the taxable years ending within its base period and prior to the taxable year in which the first change to which gross income is attributed for the purpose of this subsection occurred,

then, in computing its excess profits credit for taxable years under this subchapter which end on or after the last day of the earliest taxable

year with respect to which the requirements of paragraphs (1), (2), and (3) are satisfied, its average base period net income determined under this section shall be the amount computed under subsection (b).

(b) *Average Base Period Net Income.*—The average base period net income determined under this section shall be computed as follows:

(1) By multiplying the amount of the taxpayer's total assets for (A) the last day of its taxable year immediately preceding its first taxable year under this subchapter, or (B) the last day of the taxable year in which the taxpayer first meets the requirements of subsection (a), whichever day is later, by the base period rate of return, proclaimed by the Secretary under section 447, for the taxpayer's industry classification.

(2) By subtracting from the amount ascertained under paragraph (1) the total interest paid or incurred by the taxpayer for the 12 months ending with whichever day is used under such paragraph.

(c) *Taxpayer's Industry Classification.*—For the purposes of this section, the taxpayer's industry classification shall be the industry classification under section 447 to which is attributable the largest amount of the taxpayer's gross receipts for the taxable year which includes whichever day is used under subsection (b).

* * * * *

(e) *Average Monthly Excess Profits Net Income.*—For the purposes of subsection (a)(3)—

(1) The excess profits net income for any year shall be computed by making the adjustments provided in section 433(b) as though such section were applicable to all taxable years.

(2) The average monthly excess profits net income for any period of two or more taxable

years shall be determined (A) by computing the aggregate of the excess profits net income for all taxable years within such period, (B) by subtracting from such aggregate the aggregate amount of the deficits in excess profits net income for all taxable years within such period, and (C) by dividing the amount ascertained under (B) by the total number of months in such taxable years.

(3) The average monthly excess profits net income determined for any period shall in no case be less than zero.

(f) [as amended by Sec. 511, Revenue Act of 1951, *supra*] *Rules for Application of Section.*—

(1) The benefits of this section shall not be allowed unless the taxpayer makes application therefor in accordance with section 447(e).

(2) If after the end of the base period of the taxpayer there was a substantial change in the products produced by the taxpayer, such change shall, for the purpose of subsection (a)(1), be considered to have occurred on the last day of its base period if the taxpayer prior to July 1, 1950, commenced the construction of the facilities for the production of such new product, and if such construction and the production of such new product is in furtherance of a course of action to which the taxpayer (or a corporation with which the taxpayer has the privilege under section 141 of filing a consolidated return for its first taxable year under this subchapter) was committed prior to the close of the base period by contract with another person, which contract granted a license, franchise, or similar right essential for the production of such new product.

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(26 U.S.C. 1952 ed., Sec. 443.)

SEC. 444 [as amended by Sec. 520, Revenue Act of 1951, *supra*] AVERAGE BASE PERIOD NET INCOME—INCREASE IN CAPACITY FOR PRODUCTION OR OPERATION.

(a) *In General.*—If a taxpayer which commenced business on or before the first day of its base period establishes that, during the 36-month period ending on the last day of its base period, there was an increase, as defined in subsection (b), in its capacity for production or operation, the taxpayer's average base period net income determined under this section shall be the amount computed under subsection (c).

* * * * *

(c) *Average Base Period Net Income.*—The average base period net income determined under this section shall be computed as follows:

(1) By multiplying the amount of the taxpayer's total assets for the last day of its taxable year immediately preceding its first taxable year under this subchapter by the base period rate of return, proclaimed by the Secretary under section 447, for the taxpayer's industry.

(2) By subtracting from the amount ascertained under paragraph (1) an amount equal to the total interest paid or incurred by the taxpayer for the 12 months ending with the end of such immediately preceding taxable year.

* * * * *

(f) *Rules for Application of Section.*—

(1) The benefits of this section shall not be allowed unless the taxpayer makes application therefor in accordance with section 447(e).

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(26 U.S.C. 1952 ed., Sec. 444.)

SEC. 445. AVERAGE BASE PERIOD NET INCOME—NEW CORPORATION.

(a) *New Corporation.*—A taxpayer which commenced business after the first day of its base period shall, except as provided in subsection (g), be considered a new corporation for the purposes of this section, and its average base period net income determined under this section shall be the amount computed under subsection (b).

(b) *Average Base Period Net Income.*—The average base period net income of a new corporation determined under this section shall be computed as follows:

(1) For the purpose of determining the excess profits credit for any of the taxpayer's first three taxable years which is a taxable year under this subchapter—

(A) By multiplying the amount of the total assets for such taxable year (determined under subsection (c)), held by the taxpayer in good faith for the purposes of the business, by the base period rate of return, proclaimed by the Secretary under section 447, for the taxpayer's industry classification.

(B) By subtracting from the amount ascertained under subparagraph (A) the total interest paid or incurred by the taxpayer for the 12 months ending with the last day of such taxable year.

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(26 U.S.C. 1952 ed., Sec. 445.)

SEC. 446. AVERAGE BASE PERIOD NET INCOME—DEPRESSED INDUSTRY SUBGROUPS.

(a) *In General.*—If a taxpayer which commenced business or or before the first day of its base period is a member of a depressed industry subgroup, as defined in subsection (c), its average base period net income determined

under this section shall be the amount computed under subsection (b).

(b) *Average Base Period Net Income.*—The average base period net income determined under this section shall be computed as follows:

(1) By determining the amount of the taxpayer's total assets for the last day of each of its taxable years ending after the first day of its base period and prior to the first day of its first taxable year under this subchapter.

(2) By computing the average of the amounts ascertained under paragraph (1).

(3) By multiplying the amount ascertained under paragraph (2) by the adjusted rate of return, proclaimed by the Secretary under subsection (e), for the taxpayer's industry subgroup.

* * * * *

(c) *Depressed Industry Subgroups.*—The Secretary shall determine and proclaim as a depressed industry subgroup any industry subgroup (defined in accordance with subsection (f)) having a rate of return (determined under subsection (d)(1)) for the period 1946 through 1948 which is less than 63 per centum of its rate of return (determined under subsection (d)(2)) for the period 1938 through 1948.

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(26 U.S.C. 1952 ed., Sec. 446.)

SEC. 447. INDUSTRY BASE PERIOD RATES OF RETURN.

(a) *Base Period Yearly Rate of Return.*—The Secretary shall determine and proclaim for each industry classification in subsection (c) a rate of return (computed to the nearest thousandth) for each of the four years 1946 through 1949. The yearly rate of return for each industry classification shall be obtained by dividing the sum of the aggregate net income (computed without regard to the net operating loss deduction provided in section 23(s)) and

the aggregate interest deduction shown on the income tax returns filed by the corporations in such classification submitting balance sheets, by the aggregate total assets of such corporations as of the close of the taxable year for which such returns were filed. Such aggregate net income, interest deduction and total assets for each such year shall include the amounts reported on the income tax returns for the calendar year and the amounts reported on returns for other taxable years the greater part of which falls in such calendar year. The determinations by the Secretary required under this section shall be made on the basis of returns regularly used by the Treasury Department in compiling published statistics from income tax returns, computing all rates of return after giving effect to renegotiation of contracts in accordance with renegotiation statistics published in the statistics compiled with respect to industry classifications.

(b) *Base Period Rate of Return.*—The Secretary shall determine and proclaim for each industry classification in subsection (c) a rate of return (computed to the nearest thousandth) for the four year period 1946 through 1949. Such base period rate of return for each industry classification shall be obtained by aggregating the net income and interest deduction (such amounts being determined as provided under subsection (a)) for such four years and dividing the aggregate by the sum of the total assets (determined as provided under subsection (a)) for such four years.

(c) *Industry Classification.*—For purposes of this subchapter the classification of taxpayers by industry shall be as provided in the table below. Each such industry classification is defined in accordance with the specifications shown in the Standard Industrial Classification Manual (prepared by the Division of Statistical Standards, Bureau of the

Budget) for the major industry group or groups the numbers of which appear opposite such classification.

* * * * *

(26 U.S.C. 1952 ed., Sec. 447.)

SEC. 450. CORPORATIONS ENGAGED IN MINING OF STRATEGIC MINERALS.

(a) *Exemption From Tax.*—In the case of any domestic corporation engaged in the mining of a strategic mineral, the portion of the adjusted excess profits net income attributable to such mining in the United States shall be exempt from the tax imposed by this subchapter. The tax on the remaining portion of such adjusted excess profits net income shall be an amount which bears the same ratio to the tax computed without regard to this section as such remaining portion bears to the entire adjusted excess profits net income.

(b) [as amended by Sec. 522, Revenue Act of 1951, *supra*] *Definitions.*—For the purposes of this section—

(1) the term "strategic mineral" means antimony, chromite, bauxite, manganese * * * and any other mineral which the certifying agency has certified to the Secretary as being essential to the defense effort of the United States and as not having been normally produced in appreciable quantities within the United States.

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(26 U.S.C. 1952 ed., Sec. 450.)

SEC. 453. NONTAXABLE INCOME FROM CERTAIN MINING AND TIMBER OPERATIONS, AND FROM NATURAL GAS PROPERTIES.

(a) *Definitions.*—For the purposes of this section and section 433(a)—

(1) *Producer; lessor; natural gas company.*—The term "producer" means a corporation which extracts minerals from a min-

eral property, or which cuts logs from a timber block, in which an economic interest is owned by such corporation. The term "lessor" means a corporation which owns an economic interest in a mineral property or a timber block, and is paid in accordance with the number of mineral units or timber units recovered therefrom by the person to which such property or block is leased. The term "natural gas company" means a corporation engaged in the withdrawal, or transportation by pipe line, of natural gas.

(2) *Mineral unit; natural gas unit; and timber unit.*—The term "mineral unit" means a unit of metal, coal, or nonmetallic substance in the minerals recovered from the operation of a mineral property. The term "natural gas unit" means a unit of natural gas sold by a natural gas company. The term "timber unit" means a unit of timber recovered from the operation of a timber block.

(3) *Excess output.*—The term "excess output" means the excess of the mineral units, natural gas units, or timber units for the taxable year over the normal output.

(4) *Normal output.*—The term "normal output" means the average annual mineral units, or the average annual timber units, as the case may be, recovered in the taxable years beginning after December 31, 1945, and not ending after June 30, 1950 (hereinafter in this section called "normal period"), of the person owning the mineral property or the timber block (whether or not the taxpayer). The term "normal output", in the case of a natural gas company, means the average annual natural gas units sold in the taxable years beginning after December 31, 1945, and not ending after June 30, 1950, (hereinafter in this section called "normal period"), of the person owning the natural

gas property (whether or not the taxpayer). The average annual mineral units, natural gas units, or timber units shall be computed by dividing the aggregate of such mineral units, natural gas units, or timber units for the normal period by the number of months for which the mineral property, natural gas property, or timber block was in operation during the normal period and by multiplying the amount so ascertained by twelve. * * *

(5) *Natural gas property.*—The term "natural gas property" means the property of a natural gas company used for the withdrawal, storage, and transportation by pipe line, of natural gas, excluding any part of such property which is an emergency facility under section 124A.

(6) *Mineral property.*—The term "mineral property" means a mineral deposit, the development and plant necessary for the extraction of the deposit, and so much of the surface of the land as is necessary for purposes of such extraction.

(7) *Minerals.*—The term "minerals" means ore of the metals, coal, and such nonmetallic substances as abrasives, asbestos, asphaltum * * *.

* * * * *

(11) *Estimated recoverable units.*—The term "estimated recoverable units" means the estimated number of units of metal, coal, or nonmetallic substances in the estimated recoverable minerals from the mineral property at the end of the taxable year plus the excess output for such year. All estimates shall be subject to the approval of the Secretary, the determinations of whom for the purposes of this section, shall be final and conclusive.

(12) *Exempt excess output.*—The term "exempt excess output" for any taxable year means a number of units equal to the follow-

ing percentages of the excess output for such year:

* * * * *

(b) *Nontaxable Income From Exempt Excess Output.*—

(1) *General rule.*—For any taxable year for which the excess output of mineral property which was in operation during the normal period exceeds 5 per centum of the estimated recoverable units from such property, the nontaxable income from exempt excess output for such year shall be an amount equal to the exempt excess output for such year multiplied by the normal unit profit, but such amount shall not exceed the net income (computed with the allowance for depletion) attributable to the excess output for such year.

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(26 U.S.C. 1952 ed., Sec. 453.)

SEC. 456. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) *Definitions.*—For the purposes of this section—

(1) *Abnormal income.*—The term "abnormal income" means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

(3) *Net abnormal income.*—The term "net abnormal income" means the amount of the abnormal income less, under regulations prescribed by the Secretary, (A) 115 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any costs or deductions relating to such abnormal income, allowable in determining the normal-tax net income for the taxable year, as the excess of the amount of such abnormal income over 115 per centum of such average amount bears to the amount of such abnormal income.

(b) *Amount Attributable to Other Years.*—The amount of the net abnormal income that is attributable to any previous or future tax-

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able year or years shall be determined under regulations prescribed by the Secretary. In the case of amounts otherwise attributable to future taxable years, if the taxpayer either transfers substantially all its properties or distributes any property in complete liquidation, then there shall be attributable to the first taxable year in which such transfer or distribution occurs (or if such year is previous to the taxable year in which the abnormal income is includible in gross income to such latter taxable year) all amounts so attributable to future taxable years not included in the gross income for a previous taxable year.

(c) *Computation of Tax for Current Taxable Year.*—The tax under this subchapter for the taxable year, in which the whole of such abnormal income would without regard to this section be includible, shall not exceed the sum of:

(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

(2) The aggregate of the increase in the tax under this subchapter for the taxable year (computed under paragraph (1)) and for each previous taxable year which would have resulted if, for each previous taxable year to which any portion of such net abnormal income is attributable, an amount equal to such portion had been included in the gross income for such previous taxable year.

(d) *Computation of Tax for Future Taxable Year.*—The amount of the net abnormal income attributable to any future taxable year shall, for the purposes of this subchapter, be included in the gross income for such taxable year.

(1) The tax under this subchapter for such future taxable year shall not exceed the sum of—

(A) the tax under this subchapter for such future taxable year computed without the inclusion in gross income of the portion of such net abnormal income which is attributable to such year; and

(B) the decrease in the tax under this subchapter for the previous taxable year in which the whole of such abnormal income would, without regard to this section, be includible which resulted by reason of the computation of such tax for such previous taxable year under the provisions of subsection (c); but the amount of such decrease shall be diminished by the aggregate of the increases in the tax under this subchapter for the future taxable year as computed under subparagraph (A) and for the taxable years intervening between such previous taxable year and such future taxable year which have resulted because of the inclusion of the portions of such net abnormal income attributable to such intervening years in the gross income for such intervening years.

(2) If, in the application of subsection (c), net abnormal income from more than one taxable year is attributable to any future taxable year, paragraph (1) of this subsection shall be applied with respect to such future taxable year in the order of the taxable years from which the net abnormal income is attributable beginning with the earliest, as if the portion of the net abnormal income from each such year was the only amount so attributable to such future taxable year, and (except in the case of the portion for the earliest previous taxable year) as if the tax under this subchapter for the future taxable year was the tax determined under paragraph (1) with respect to the portion for the next earlier previous taxable year.

(3) If in the application of paragraph (1) to any future taxable year it is determined that the decrease in tax computed under paragraph (1)(B) with respect to the net abnormal income, a portion of which is included in the gross income for the future taxable year, does not exceed the aggregate of the increases in tax computed under paragraph (1)(B) with respect to such net abnormal income, then the portions of such net abnormal income attributable to taxable years subsequent to such future taxable year shall not be included in the gross income for such subsequent taxable year. For the purpose of computing the tax under this subchapter for a taxable year subsequent to the future taxable year, the portion of net abnormal income attributable to the future taxable year shall not be included in the gross income for such future taxable year to the extent that the inclusion of such portion of net abnormal income in the gross income for such future taxable year did not result in an increase in tax for such future taxable year by reason of the provisions of paragraph (1).

(e) *Application of Section.*—This section shall be applied only for the purpose of computing the tax under this subchapter as provided in subsections (c) and (d), and shall have no effect upon the computation of base period net income. For the purposes of subsections (c) and (d)—

(1) Net abnormal income means the aggregate of the net abnormal income of all classes for one taxable year.

(2) Under regulations prescribed by the Secretary, the tax under this subchapter for previous taxable years shall be computed as if the portions of net abnormal income for each previous taxable year for which the tax was computed under this section were included in the gross income for the other pre-

vious taxable years to which said portions were attributable.

(3) If both subsections (c) and (d) are applicable to any current taxable year, subsection (d) shall be applied without regard to subsection (c), and subsection (c) shall be applied as if the tax under this subchapter, except for subsection (c), was the tax computed under subsection (d) and as if the gross income and the other amounts necessary to determine the adjusted excess profits net income were those amounts which would result in the tax computed under subsection (d).

(26 U.S.C. 1952 ed., Sec. 456.)

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## CHAPTER 2—ADDITIONAL INCOME TAXES

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### SUBCHAPTER E—EXCESS PROFITS TAX

[As added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974.]

### SEC. 710. IMPOSITION OF TAX.

(a) [as amended by Sec. 201(a), Revenue Act of 1941, c. 412, 55 Stat. 687; and Sec. 202, Revenue Act of 1942, c. 619, 56 Stat. 798]. *Imposition.*—

(1) *General Rule.*—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess-profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

* * * * *

(b) [as amended by Sec. 2(a), Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17; and Sec. 204(a), Revenue Act of 1942, *supra*]. *Definition of Adjusted Excess Profits Net Income.*—As used in this section, the term "adjusted excess profits net income" in the case

of any taxable year means the excess profits net income (as defined in section 711) minus the sum of:

(1) *Specific exemption.*—A specific exemption of $5,000;

(2) *Excess profits credit.*—The amount of the excess profits credit allowed under section 712; and

(3) *Unused excess profits credit.*—The amount of the unused excess profits credit adjustment for the taxable year, computed in accordance with subsection (c).

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(26 U.S.C. 1952 ed., Sec. 710.)

SEC. 711. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Beginning After December 31, 1939.*—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13(a)(2), for such year except that the following adjustments shall be made:

(1) *Excess profits credit computed under income credit.*—If the excess profits credit is computed under section 713, the adjustments shall be as follows:

* * * * *

(I) [as added by Sec. 209(a) of the Revenue Act of 1942, *supra*, and as amended by Sec. 208(d) of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Nontaxable income of certain industries with depletable resources.*—In the case of a producer of minerals, or a producer of logs or lumber from a timber block, or a lessor of mineral property, or a timber block, as defined in section 735, there shall be excluded nontaxable income from exempt excess output of mines and timber blocks provided in section 735; in the case of a natural gas company, as defined in section 735, there shall be excluded nontaxable income from exempt excess

output provided in section 735; and in the case of a producer of minerals or a producer of logs or lumber from a timber block, there shall be excluded nontaxable bonus income provided in section 735. In respect of nontaxable bonus income provided in section 735(c), a corporation described in section 735(c)(2) shall be deemed a producer of minerals for the purposes of this subparagraph.

* * * * *

(2) *Excess profits credit computed under invested capital credit.*—If the excess profits credit is computed under section 714, the adjustments shall be as follows:

* * * * *

(b) [as amended by Sec. 3, Excess Profits Tax Amendments of 1941, *supra*]. *Taxable Years in Base Period.*—

(1) *General rule and adjustments.*—The excess profits net income for any taxable year subject to the Revenue Act of 1936 shall be the normal-tax net income, as defined in section 13(a) of such Act; and for any other taxable year beginning after December 31, 1937, and before January 1, 1940, shall be the special-class net income, as defined in section 14(a) of the applicable revenue law. In either case the following adjustments shall be made (for additional adjustments in case of certain reorganizations, see section 742(e)):

* * * * *

(H) *Payment of judgments, and so forth.*—Deductions attributable to any claim, award, judgment, or decree against the taxpayer, or interest on any of the foregoing, if abnormal for the taxpayer, shall not be allowed, and if normal for the taxpayer, but in excess of 125 per centum of the average amount of such deductions in

the four previous taxable years, shall be disallowed in an amount equal to such excess;

(I) *Intangible drilling and development costs.*—Deductions attributable to intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, and for development costs in the case of mines, if abnormal for the taxpayer, shall not be allowed, and if normal for the taxpayer, but in excess of 125 per centum of the average amount of such deductions in the four previous taxable years, shall be disallowed in an amount equal to such excess; and

(J) *Abnormal deductions.*—Under regulations prescribed by the Commissioner, with the approval of the Secretary, for the determination, for the purposes of this subparagraph, of the classification of deductions—

(i) Deductions of any class shall not be allowed if deductions of such class were abnormal for the taxpayer, and

(ii) If the class of deductions was normal for the taxpayer, but the deductions of such class were in excess of 125 per centum of the average amount of deductions of such class for the four previous taxable years, they shall be disallowed in an amount equal to such excess.

(K) *Rules for application of subparagraphs (H), (I), and (J).*—For the purposes of subparagraphs (H), (I), and (J)—

* * * * *

(ii) Deductions shall not be disallowed under such subparagraphs unless the taxpayer establishes that the abnormality or

excess is not a consequence of an increase in the gross income of the taxpayer in its base period or a decrease in the amount of some other deduction in its base period, and is not a consequence of a change at any time in the type, manner of operation, size, or condition of the business engaged in by the taxpayer.

* * * * *

(26 U.S.C. 1956 ed., Sec. 711.)

SEC. 712 [as amended by Sec. 13, Excess Profits Tax Amendments of 1941, *supra*]. EXCESS PROFITS CREDIT—ALLOWANCE.

(a) *Domestic Corporations.*—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 712.)

SEC. 713 [as amended by Sec. 4, Excess Profits Tax Amendments of 1941, *supra*, and Sec. 214(a), Sec. 215, and Sec. 228(e)(2), Revenue Act of 1942, *supra*]. EXCESS PROFITS CREDIT—BASED ON INCOME.

(a) *Amount of Excess Profits Credit.*—The excess profits credit for any taxable year, computed under this section, shall be—

(1) *Domestic corporations.*—In the case of a domestic corporation—

(A) 95 per centum of the average base period net income,

(B) Plus 8 per centum of the net capital addition as defined in subsection (g), or

(C) Minus 6 per centum of the net capital reduction as defined in subsection (g).

* * * * *

(b) *Base Period.*—

(1) *Definition.*—As used in this section the term "base period"—

(A) If the corporation was in existence during the whole of the forty-eight months preceding the beginning of its first taxable year under this subchapter, means the period commencing with the beginning of its first taxable year beginning after December 31, 1935, and ending with the close of its last taxable year beginning before January 1, 1940; and

* * * * *

(2) *Division into halves.*—For the purposes of subsections (d) and (f) the base period of the taxpayer shall be divided into halves, the first half to be composed of one-half the entire number of months in the base period and to begin with the beginning of the base period.

* * * * *

(d) *Average Base Period Net Income—Determination.*—

(1) *Definition.*—For the purposes of this section the average base period net income of the taxpayer shall be the amount determined under subsection (e), subject to the exception that if the aggregate excess profits net income for the last half of its base period, reduced by the aggregate of the deficits in excess profits net income for such half, is greater than such aggregate so reduced for the first half, then the average base period net income shall be the amount determined under subsection (f), if greater than the amount determined under subsection (e).

(2) For the purposes of subsections (e) and (f), if the taxpayer was in existence dur-

ing only part of the 48 months preceding the beginning of its first taxable year under this subchapter, its excess profits net income—

* * * * *

(3) In no case shall the average base period net income be less than zero.

* * * * *

(e) *Average Base Period Net Income—General Average.*—The average base period net income determined under this subsection shall be determined as follows:

(1) By computing the aggregate of the excess profits net income for each of the taxable years of the taxpayer in the base period, reduced by the sum of the deficits in excess profits net income for each of such years. If the excess profits net income (or deficit in excess profits net income) for one taxable year in the base period divided by the number of months in such taxable year is less than 75 per centum of the aggregate of the excess profits net income (reduced by deficits in excess profits net income) for the other taxable years in the taxpayer's base period divided by the number of months in such other taxable years (herein called "average monthly amount") the amount used for such one year under this paragraph shall be 75 per centum of the average monthly amount multiplied by the number of months in such one year, and the year increased under this sentence shall be the year the increase in which will produce the highest average base period net income;

(2) By dividing the amount ascertained under paragraph (1) by the total number of months in all such taxable years; and

(3) By multiplying the amount ascertained under paragraph (2) by twelve.

(f) *Average Base Period Net Income—Increased Earnings in Last Half of Base Period.*—The average base period net income

determined under this subsection shall be determined as follows:

(1) By computing, for each of the taxable years of the taxpayer in its base period, the excess profits net income for such year, or the deficit in excess profits net income for such year;

(2) By computing for each half of the base period the aggregate of the excess profits net income for each of the taxable years in such half, reduced, if for one or more of such years there was a deficit in excess profits net income, by the sum of such deficits. For the purposes of such computation, if any taxable year is partly within each half of the base period there shall be allocated to the first half an amount of the excess profits net income or deficit in excess profits net income, as the case may be, for such taxable year, which bears the same ratio thereto as the number of months falling within such half bears to the entire number of months in such taxable year; and the remainder shall be allocated to the second half;

(3) If the amount ascertained under paragraph 2 for the second half is greater than the amount ascertained for the first half, by dividing the difference by two;

(4) By adding the amount ascertained under paragraph (3) to the amount ascertained under paragraph (2) for the second half of the base period;

(5) By dividing the amount found under paragraph (4) by the number of months in the second half of the base period and by multiplying the result by twelve;

(6) The amount ascertained under paragraph (5) shall be the average base period net income determined under this subsection, except that the average base period net income determined under this subsection shall in no case be greater than the highest excess

profits net income for any taxable year in the base period. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 713.)

SEC. 721 [as amended by Sec. 5, Excess Profits Tax Amendments of 1941, *supra*, and Sec. 221(a), Revenue Act of 1942, *supra*]. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) *Definitions.*—For the purposes of this section—

(1) *Abnormal income.*—The term "abnormal income" means income of any class includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income constituting an amount payable under a contract the performance of which required more than 12 months;[1] or

[1] Subparagraph (B) of Section 721(a)(2) was made inapplicable to taxable years beginning after December 31, 1941, by Section 222(f) of the Revenue Act of 1942, which Act, by Section 222(d), added Section 736 to the Code to provide relief for taxpayers with income from long-term contracts.

(C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting; or

(E) In the case of a lessor of real property, income included in gross income for the taxable year by reason of the termination of the lease; or

(F) Income consisting of dividends on stock of foreign corporations, except foreign personal holding companies.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.

(3) *Net abnormal income.*—The term "net abnormal income" means the amount of the abnormal income less, under regulations prescribed by the Commissioner with the approval of the Secretary, (A) 125 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any direct costs or expenses, deductible in determining the normal-tax net income of the taxable year, through the expenditure of which such abnormal income was in whole or in part derived as the excess of the amount of such abnormal income over 125 per centum of such

average amount bears to the amount of such abnormal income.

(b) *Amount Attributable to Other Years.*—The amount of the net abnormal income that is attributable to any previous or future taxable year or years shall be determined under regulations prescribed by the Commissioner with the approval of the Secretary. * * *

(c) *Computation of Tax for Current Taxable Year.*—The tax under this subchapter for the taxable year, in which the whole of such abnormal income would without regard to this section be includible, shall not exceed the sum of:

(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

(2) The aggregate of the increase in the tax under this subchapter for the taxable year (computed under paragraph (1) and for each previous taxable year which would have resulted if, for each previous taxable year to which any portion of such net abnormal income is attributable, an amount equal to such portion had been included in the gross income for such previous taxable year.

(d) *Computation of Tax for Future Taxable Year.*—* * *

* * * * *

(e) *Application of Section.*—This section shall be applied only for the purpose of computing the tax under this subchapter as provided in subsections (c) and (d), and shall have no effect upon the computation of base period net income. For the purposes of subsections (c) and (d)—

(1) Net abnormal income means the aggregate of the net abnormal income of all classes for one taxable year.

(2) Under regulations prescribed by the Commissioner with the approval of the Secretary, the tax under this subchapter for previous taxable years shall be computed as if the portions of net abnormal income for each previous taxable year for which the tax was computed under this section were included in the gross income for the other previous taxable years to which such portions were attributable.

(3) If both subsections (c) and (d) are applicable to any current taxable year, subsection (d) shall be applied without regard to subsection (c), and subsection (c) shall be applied as if the tax under this subchapter, except for subsection (c), was the tax computed under subsection (d) and as if the gross income and the other amounts necessary to determine the adjusted excess profits net income were those amounts which would result in the tax computed under subsection (d).

(f) *Abnormal Income From Exploration, Etc.*—If, by reason of taking into account, in determining constructive average base period net income under section 722, exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months, such constructive average base period net income is higher than it would be without such taking into account, only such portion of the income in the taxable year resulting from such activity which is of a class described in subsection (a)(2)(C) as is attributable to another taxable year under this subchapter shall be deemed attributable to a year other than the taxable year.

(26 U.S.C. 1952 ed., Sec. 721.)

SEC. 722 [as amended by Sec. 222(a), Revenue Act of 1942, *supra*, and Sec. 1, Act of December 17, 1943, c. 346, 57 Stat. 601]. GENERAL RELIEF — CONSTRUCTIVE AVERAGE BASE PERIOD NET INCOME

(a) *General Rule.*—In any case in which the taxpayer establishes that the tax computed under this subchapter (without the benefit of this section) results in an excessive and discriminatory tax and establishes what would be a fair and just amount representing normal earnings to be used as a constructive average base period net income for the purposes of an excess profits tax based upon a comparison of normal earnings and earnings during an excess profits tax period, the tax shall be determined by using such constructive average base period net income in lieu of the average base period net income otherwise determined under this subchapter. In determining such constructive average base period net income, no regard shall be had to events or conditions affecting the taxpayer, the industry of which it is a member, or taxpayers generally occurring or existing after December 31, 1939, except that, in the cases described in the last sentence of section 722(b)(4) and in section 722(c), regard shall be had to the change in the character of the business under section 722(b)(4) or the nature of the taxpayer and the character of its business under section 722(c) to the extent necessary to establish the normal earnings to be used as the constructive average base period net income.

(b) *Taxpayers Using Average Earnings Method.*—The tax computed under this subchapter (without the benefit of this section) shall be considered to be excessive and discriminatory in the case of a taxpayer entitled to use the excess profits credit based on income pursuant to section 713, if its average base period

net income is an inadequate standard of normal earnings because—

(1) in one or more taxable years in the base period normal production, output, or operation was interrupted or diminished because of the occurrence, either immediately prior to, or during the base period, of events unusual and peculiar in the experience of such taxpayer,

(2) the business of the taxpayer was depressed in the base period because of temporary economic circumstances unusual in the case of such taxpayer or because of the fact that an industry of which such taxpayer was a member was depressed by reason of temporary economic events unusual in the case of such industry,

(3) the business of the taxpayer was depressed in the base period by reason of conditions generally prevailing in an industry of which the taxpayer was a member, subjecting such taxpayer to

(A) a profits cycle differing materially in length and amplitude from the general business cycle, or

(B) sporadic and intermittent periods of high production and profits, and such periods are inadequately represented in the base period,

(4) the taxpayer, either during or immediately prior to the base period, commenced business or changed the character of the business and the average base period net income does not reflect the normal operation for the entire base period of the business. If the business of the taxpayer did not reach, by the end of the base period, the earning level which it would have reached if the taxpayer had commenced business or made the change in the character of the business two years before it did so, it shall be deemed to have commenced the business or made the change

at such earlier time. For the purposes of this subparagraph, the term "change in the character of the business" includes a change in the operation or management of the business, a difference in the products or services furnished, a difference in the capacity for production or operation, a difference in the ratio of nonborrowed capital to total capital, and the acquisition before January 1, 1940, of all or part of the assets of a competitor, with the result that the competition of such competitor was eliminated or diminished. Any change in the capacity for production or operation of the business consummated during any taxable year ending after December 31, 1939, as a result of a course of action to which the taxpayer was committed prior to January 1, 1940, or any acquisition before May 31, 1941, from a competitor engaged in the dissemination of information through the public press, of substantially all the assets of such competitor employed in such business with the result that competition between the taxpayer and the competitor existing before January 1, 1940, was eliminated, shall be deemed to be a change on December 31, 1939, in the character of the business, or

(5) of any other factor affecting the taxpayer's business which may reasonably be considered as resulting in an inadequate standard of normal earnings during the base period and the application of this section to the taxpayer would not be inconsistent with the principles underlying the provisions of this subsection, and with the conditions and limitations enumerated therein.

* * * * *

(d) *Application for Relief Under This Section.*—The taxpayer shall compute its tax, file its return, and pay the tax shown on its return under this subchapter without the application of this section, except as provided in section

710(a)(5). The benefits of this section shall not be allowed unless the taxpayer within the period of time prescribed by section 322 and subject to the limitation as to amount of credit or refund prescribed in such section makes application therefor in accordance with regulations prescribed by the Commissioner with the approval of the Secretary. If a constructive average base period net income has been determined under the provisions of this section for any taxable year, the Commissioner may, by regulations approved by the Secretary, prescribe the extent to which the limitations prescribed by this subsection may be waived for the purpose of determining the tax under this subchapter for a subsequent taxable year.

* * * * *

(f) *Mining Corporations.*—In the case of a taxpayer to which section 711(a)(1)(I) or section 711(a)(2)(K) applies, if its constructive average base period net income is established under this section, there shall also be determined a fair and just amount to be used as normal output and normal unit profit for the purposes of section 735.

(26 U.S.C. 1952 ed., Sec. 722.)

SEC. 732 [as added by Sec. 9, Excess Profits Tax Amendments of 1941, *supra;* and as amended by Sec. 222(c), Revenue Act of 1942, *supra;* Sec. 2, Joint Resolution of June 30, 1945, c. 211, 59 Stat. 295; and Sec. 203(a), Act of December 29, 1945, c. 652, 59 Stat. 669]. REVIEW OF ABNORMALITIES BY THE TAX COURT OF THE UNITED STATES.

(a) *Petition to the Tax Court.*—If a claim for refund of tax under this subchapter for any taxable year is disallowed in whole or in part by the Commissioner, and the disallowance relates to the application of section 711(b)(1)(H), (I), (J), or (K), section 721, or section

722, relating to abnormalities the Commissioner shall send notice of such disallowance to the taxpayer by registered mail. Within ninety days after such notice is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the ninetieth day) the taxpayer may file a petition with the Tax Court for a redetermination of the tax under this subchapter. If such petition is so filed, such notice of disallowance shall be deemed to be a notice of deficiency for all purposes relating to the assessment and collection of taxes or the refund or credit of overpayments.

(b) *Deficiency Found by the Tax Court in case of Claim.*—If the Tax Court finds that there is no overpayment of tax in respect of any taxable year in respect of which the Commissioner has disallowed, in whole or in part, a claim for refund described in subsection (a) and the Tax Court further finds that there is a deficiency for such year, the Tax Court shall have jurisdiction to determine the amount of such deficiency and such amount shall, when the decision of the Tax Court becomes final, be assessed and shall be paid upon notice and demand from the collector.

(c) *Finality of Determination.*—If in the determination of the tax liability under this subchapter the determination of any question is necessary solely by reason of section 711(b)(1) (H), (I), (J), or (K), section 721, or section 722, the determination of such question shall not be reviewed or redetermined by any court or agency except the Tax Court.

(d) *Review by Special Division of the Tax Court.*—The determinations and redeterminations by any division of the Tax Court involving any question arising under section 711(a)(2)(C) or section 722 with respect to any taxable year shall be reviewed by a special division of the Tax Court which shall be constituted by the presiding judge and consist of not less than

three judges of the Tax Court. The decisions of such special division shall not be reviewable by the Tax Court and shall be deemed decisions of the Tax Court.

(26 U.S.C. 1952 ed., Sec. 732.)

Treasury Regulations 130, relating to the Excess Profits Tax, promulgated (in 1951) under the Internal Revenue Code of 1939, as amended (for taxable years ending after June 30, 1950):

SEC. 40.456–2 [as amended by T.D. 6026, 1953–2 Cum. Bull. 235]. *Classification of Income.*—

(a) Section 456(a)(2) (A), (B), (C), and (D) sets forth four separate classes of income. All the income which reasonably is classifiable in more than one class shall be classified under the one which the taxpayer irrevocably elects. Such election shall be made in the manner prescribed in section 40.456–3. The classification of income for any year must be consistent with the classification made under section 456 for previous years. The classification must also be consistent with any classification made in applying section 433(b)(9) to the taxpayer.

(b) Other income, not within a class described in subparagraphs (A)–(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)–(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not consti-

tute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)..

Rev. Rul. 236, 1953–2 Cum. Bull. 236:

1. *Purpose.*—The purpose of this Revenue Ruling is to state the position of the Internal Revenue Service with respect to the application of section 456 of the Internal Revenue Code (relating to the excess-profits tax) to taxpayers engaged in the extraction of petroleum and natural gas.

2. *Exploration, discovery, or prospecting.*—Exploration or prospecting by a taxpayer begins with the first field work designed to determine whether to acquire or retain the acreage in the area in which a discovery is later made. (See I.T. 4006, C.B. 1950–1, 38.) It does not include the general research of published reports to determine where exploration might be profitable. Exploration is ended and discovery occurs for a pool when a well is completed that proves the presence of oil or gas in commercial quantities. Subsequent drilling in the pool, while it may contain a large element of risk, constitutes exploitation to reap the benefits of the discovery. To the extent that "development" is the equivalent of "exploration" or "discovery," it may result in abnormal income under section 456; to the extent that "development" is the equivalent of "exploitation," it will not result in any abnormal income within the meaning of section 456.

3. *Period of exploration, discovery, or prospecting.*—To qualify under section 456(a)(2)(B) income must result from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months. This means that the elapsed time between the commencement of exploration

or prospecting and the resulting discovery, as defined in paragraph 2, exclusive of any intervening periods of inactivity, must total more than 12 months. Only the actual time consumed from the initial steps in the exploration or prospecting to the final completion of the discovery well that proved the presence of oil or gas in commercial quantities is to be considered in measuring the time elapsed.

4. *Class of income.*—The entire income of a taxpayer which results from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months, constitutes a single class of income.

5. *Determination of abnormal income.*—That part of the gross income from the sale of oil and/or gas from properties of the taxpayer which meets the other requirements of section 456 and which is attributable to the exploration, discovery, or prospecting of such properties constitutes abnormal income within the meaning of section 456(a)(2)(B). That part of the gross income from the sale of oil and/or gas from the taxpayer's properties which is attributable to the exploitation of such properties, however, does not under any circumstances constitute abnormal income within the meaning of section 456(a)(2)(B). Any method of allocation will be acceptable which reasonably determines the portions of income which are attributable to exploration, discovery, or prospecting of the properties and the portions of income which are attributable to the development or exploitation of the properties in view of the respective risks undertaken. For example, an amount equal to the total amount which would be realized over the life of the properties as overriding royalties if the properties had been subleased on the discovery date (or the actual amount so realized if the properties in fact were subleased) qualifies as

abnormal income. Such amount will not include any income which would be realized by the sublessee as the result of exploitation of such properties.

The amount which would be equal to the assumed overriding royalties (if the properties were not in fact subleased), or the income otherwise determined as attributable to exploration, discovery, or prospecting of the properties, must be established in the light of the conditions and circumstances known at the discovery date, regardless of later information concerning the properties. The terms of an assumed sublease shall be determined on the basis of a transfer between a willing sublessor and a willing sublessee as of the discovery date. Due weight shall be given to any and all facts and evidence having a bearing on the amount of such overriding royalties, or income attributable to exploration, discovery, or prospecting, such as the actual subleasing of similar properties, or the determination by an analytical method which will reasonably apportion the anticipated, undiscounted net earnings from such properties between the interest of the explorer, discoverer, or prospector, and the interest of a developer or exploiter. In the determination of net earnings, deductions from anticipated gross income shall include not only the estimated direct operating costs attributable to the production of oil and/or gas but also the estimated costs of drilling subsequent wells, general overhead, and any other deductions attributable to exploitation of the properties.

A method of determining abnormal income may be illustrated as follows: Assume that as of the date of discovery of a new pool, the estimated undiscounted net earnings from the taxpayer's properties are $1,250,000. Assume further that these properties could be subleased on a 40–60 basis (i.e. 40% of the estimated net

earnings attributed to the sublessor and 60% to the sublessee). These are all facts with respect to the properties to be determined by expert analysis such as by a petroleum engineer. Under these assumptions the sublessor's share of the total estimated net earnings is $500,000, and if the total estimated recoverable oil is 1,000,000 barrels, 50 cents of the income realized from each barrel of oil will be the income resulting from exploration, discovery, and prospecting (without regard to the ultimate amount of oil recovered from the property), and such 50 cents per barrel thus will represent abnormal income.

6. *Items of abnormal income.*—An item of abnormal income consists of the abnormal income, as defined above, attributable to a single discovery. Thus, the amount of an item of abnormal income in any taxable year is equal to that portion of the income, attributable to the discovery, realized in such taxable year from a particular oil and/or gas pool which is proved by a single discovery well. For the purposes of this Revenue Ruling, a "pool" means any underground accumulation of crude petroleum or associated hydrocarbon substances including, but not limited to, natural gas, constituting a single and separate reservoir or source of supply within a field. The probable limits of such new pool, as determined by the best evidence available at the date of completion of the discovery well, thus define the area within which all leases or properties owned at the time by the discoverer would be included in the discovery. Later discoveries of new pools in the same area may be made in different sands or horizons, and again the income attributable to the discovery of the new pool would be determined by the facts known as of the date of discovery. No adjustments will be made because of any subsequent information.

The abnormal income of a taxpayer for any year, either the current taxable year or one of the 4 prior taxable years, consists of the sum of the items of abnormal income, as defined above, from all discovery units of the taxpayer yielding such income in the given year.

7. *Net abnormal income attributable to other years.*—Net abnormal income, and items of net abnormal income, are to be determined as provided in Regulations 130, section 40.456–1. With respect, however, to the reduction for costs or deductions relating to the abnormal income called for by sections 40.456–1 (c)(3) and (d)(2), these costs and deductions other than the depletion allowable, are zero, since it is the expected *net* realization from anticipated production that is reflected in the sublessor's share of anticipated net earnings (50 cents per barrel of oil in the example given in paragraph 5) which is used to measure abnormal income. The amount of the depletion allowance relating to the abnormal income with respect to each item is an amount equal to the depletion deduction multiplied by the ratio of abnormal income to the net income before depletion. (The depletion allowance relating to the class of abnormal income is the sum of the depletion allowances relating to all of the items constituting the class.)

The amounts of net abnormal income attributable to other years are to be determined as provided in section 40.456–3. Any net abnormal income due to an increase in demand for oil or gas, as shown by appropriate sales or consumption data, is not attributable to other years, but to the current taxable year. Similarly, any net abnormal income due to increased prices is not attributable to other years; but if abnormal income has been determined by the method shown in the illustration in paragraph 5 above, or by any other method not involving fluctuating prices, then no net abnormal income

so determined will be attributable to the current taxable year by virtue of such increased prices.

Each item of net abnormal income attributable to other years is attributable to the years of exploration, discovery, or prospecting for such item in proportion to the ratio of expenditures for these activities in each such year to their total for all years.

* * * * *

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IN THE

# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1960

No. 151

JOHN T. JARECKI, former Collector of Internal Revenue, et al.,

*Petitioners,*

*vs.*

G. D. SEARLE & CO.,

*Respondent.*

**On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## BRIEF FOR RESPONDENT

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*Respondent.*

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**On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

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# BRIEF FOR RESPONDENT

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## Opinions Below

The opinion of the district court (R. 41-45) has not been officially reported. The opinion of the court of appeals (R. 49-53) is reported in 274 F. 2d 129.

## Jurisdiction

The judgment of the court of appeals was entered on January 27, 1960 (R. 54). The petition for a writ of certiorari was granted on October 10, 1960 (R. 57). The jurisdiction of this Court was invoked under 28 U.S.C. 1254(1).

## Question Presented

Is respondent entitled to a trial on the merits of its suit for refund of excess profits tax under the provisions of Section 456 of the Korean War Excess Profits Tax Act, granting relief for abnormal income? Respondent asserts that income resulting from its discovery of two breakthrough drugs effecting completely new treatments for illness qualifies for relief under this statute.

## Statute and Regulations Involved

Section 456 of the Excess Profits Tax Act of 1950, which is no longer in effect (see 67 Stat. 175), provided in pertinent part (64 Stat. 1137, 1186; Section 456 of the Internal Revenue Code of 1939, 26 U.S.C. 1952 ed., § 456):

"SEC. 456. *Abnormalities in income in taxable period.*

"(a) *Definitions.*—For the purposes of this section—

"(1) *Abnormal income.*—The term 'abnormal income' means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

"(2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

"(A) Income arising out of a claim, award,

judgment, or decree, or interest on any of the foregoing; or

"(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

"(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

"(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

* * * *

Section 40.456-2(b) of Treasury Regulations 130 (as amended by Treasury Decision 6026 of July 3, 1953; 1953-2 Cum. Bull., p. 235) provides as follows:

"Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of

income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)."

## Statement

Contrary to statements in the petitioners' brief (Br. 2, note 1; Br. 9), the facts are in dispute.[1] Many crucial facts are contested (p. 5 of March 31, 1959 transcript; see R. 47). However, certain other facts are established by the record. Respondent G. D. Searle & Co., a pharmaceutical company, seeks to recover part of the excess profits taxes paid for the years 1950 through 1952 on income resulting from its discovery of two drugs, Banthine and Dramamine (R. 3-15). Summary judgment was entered against respondent (R. 45) despite its insistence that factual issues are involved and evidence required to support its claim.

This proceeding involves respondent's right to tax relief under the Korean War Excess Profits Tax Act for income resulting from discovery of two drugs, Banthine and Dramamine. This Act permits special treatment of income resulting from discovery if the income falls within a class of "abnormal income" specified by the Act. If part of such "abnormal income" is attributable to other years, the statute mitigates in some degree the full excess profits tax impact.

One of the district court's orders in this proceeding lim-

1. The petitioners refused to join in a typical stipulation of facts. The scanty stipulation that was executed (R. 24-25) was merely intended to shorten the trial and was "subject to the right of either party to introduce * * * further evidence" at the trial (R. 24-25).

ited the substantive issue to the determination of the character or class of respondent's income from these discoveries. Other issues raised by the requirements of the Act, such as the computation of the amount of abnormal income and the years of attribution, have all been held in abeyance. (R. 25.)

Respondent appealed from a summary judgment rendered for petitioners by the district court (R. 45). The district court held that respondent's drugs were "products arising out of research and development and as such specifically prohibited by Congress from being considered discoveries within the meaning of Section 456(a)(2)(B)" (R. 43-44). Respondent also contended in the alternative that even if its income from the discoveries of Dramamine and Banthine was not the result of "discovery" within the meaning of Section 456(a)(2)(B), it constituted a separate class of abnormal income granted relief under the last sentence of Section 456(a)(2) (R. 43). The district court held, however, that "income from the sale of tangible property arising out of research and development may not be classified as abnormal" under any theory (R. 44).

Since this case arose on appeal from a summary judgment, the record contains few of the facts which respondent intended to establish at the trial. Dramamine is a new drug for the relief of motion sickness and Banthine a new drug for the treatment of peptic ulcers. Respondent advised the district court of its intent to prove that both Dramamine and Banthine were break-through discoveries involving new compositions of matter, and that their effect on the body constituted an unprecedented approach to the treatment of motion sickness and peptic ulcers (see Transcripts of both district court hearings, R. 47). Contemporary medical literature and other publications termed these two drugs *discoveries*, for, unlike all of respondent's other products,

including Pavatrine (cf. Govt. Br. 3, note 4), they were not improvements on existing drugs (cf. R. 3, 29-38). Their large sales and widespread imitations were further indicia that these drugs were genuine discoveries.

In the alternative, respondent intended to prove at the trial that it was "reasonable" and "appropriate" within the meaning of the applicable Treasury Regulations to treat the income from Dramamine and Banthine as abnormal under the last sentence of Section 456(a)(2) even if it did not qualify as "discovery" income under Section 456(a)(2)(B), since these drugs were utterly dissimilar from any of respondent's other products (see R. 3).

Respondent's income and excess profits tax payments during the three years in question totaled $9,093,230.47 (R. 16-18). Of this amount, the complaint sought to recover approximately $3,600,000 under the abnormal income provisions of the Korean War Excess Profits Tax Act (R. 41).

The court of appeals held that "discovery" in Section 456(a)(2)(B) of the 1950 Act (*supra*, p. 3) was not confined to natural resources. Concluding that factual issues were presented, the court reversed the summary judgment and held that respondent should be permitted to prove whether Dramamine and Banthine are actually discoveries (R. 53). The judgment of the court of appeals did not determine that respondent is entitled to recover any particular amount: only that respondent be given an opportunity to prove its case. The judgment leaves to the trial court all questions of determination of existence of abnormal income, including the complicated statutory computation of amount (see R. 4-6, 25).

## SUMMARY OF ARGUMENT

### I.

Section 456(a)(2)(B) of the 1950 Korean War Excess Profits Tax Act accords some relief to abnormal income resulting from a "discovery". That term is not confined to natural resources but is commonly applied to new drugs such as are involved here. *Smith, Kline & French Laboratories* v. *Clark & Clark*, 157 F. 2d 725, 729 (C.A.3, 1946), certiorari denied, 329 U. S. 796; *Wisconsin Alumni Research Foundation* v. *George A. Breon & Co.*, 85 F. 2d 166, 167, 171 (C.A.8, 1936); Webster's New International Dictionary (Unabridged 2d ed.) p. 745. In fact, at the hearings on the Korean War Excess Profits Tax Act, certain new drugs were described as discoveries. Hearings before the Senate Finance Committee on H. R. 9827, 81st Cong., 2nd Sess. (1950) p. 709. Because the word "discovery" as generally used encompasses the discovery of new drugs, summary judgment was improper.

### II.

Since Congress did not indicate otherwise, the term "discovery" must be given its ordinary meaning. *Avery* v. *Commissioner*, 292 U. S. 210, 214. Where Congress has intended to confine tax statutes to mineral deposits, it has so specified. The fact that "discovery" is used in a narrow sense in certain other statutes with different purposes, where a restrictive interpretation is expressly indicated, does not require the adoption of a similar narrow meaning in Section 456 where no limitation on the term was stated or intended. *Helvering* v. *Stockholms Enskilda Bank*, 293 U. S. 84; *Wong Kam Wo* v. *Dulles*, 236 F. 2d 622 (C.A.9, 1956). Petitioners' citations of examples of Congress' generous tax treatment of the natural resources industries are

beside the point. Unlike the provisions on which petitioners rely, neither Section 456 nor its precursor contained any language in text or heading which showed it was confined to the field of natural resources.

The aim of Congress to grant relief under Section 456 to abnormal income attributable in part to prior years would be frustrated by holding that "discovery" must be limited by the words "exploration" and "prospecting" in subparagraph (a)(2)(B). The maxim *noscitur a sociis* is not applied to limit the plain meaning of a word or where contrary to the statutory purpose. *Russell Co.* v. *United States*, 261 U. S. 514; *Helvering* v. *Stockholms Enskilda Bank*, 293 U. S. 84. Section 721 of the World War II Act, the predecessor of Section 456, was not limited to mining operations even though the same combination of exploration, prospecting and discovery was used along with other words. Section 456 was ultimately derived from Section 327(d) of the Revenue Act of 1918, under which relief was not restricted to oil, coal and gas.

The legislative history of Section 456 and its predecessors does not show that "discovery" was confined to natural resources. Although petitioners rely on the elimination of the words "research and development" during the enactment of Section 456, an amendment to the Treasury Regulations shows that Section 456 applies to discoveries, whether or not they occur from research and development. As shown by the history of other tax statutes, Congress would have used express language if it had meant to confine Section 456 discovery relief to natural resources. Neither the Committee Reports relating to the 1940 predecessor Section 721 nor the reports and Congressional debates on Section 456 show any intention to confine relief to the extractive industries. Instead, both statutory provisions were considered to have "general application".

The fact that patents are listed in Section 456(a)(2)(C) does not mean that patentable discoveries are not within Section 456(a)(2)(B), for the statute itself acknowledges that income might be "classifiable in more than one of such subparagraphs". Cf. *Securities & Exchange Commission* v. *C. M. Joiner Corp.*, 320 U. S. 344.

## III.

The main objective of the Korean War Excess Profits Tax Act was to tap profits swollen by those hostilities. However, Section 456 was enacted to provide relief where profits were not attributable to the wartime economy. In providing that Section, Congress recognized the unfairness of bunching for heavy taxation in one year income which is attributable to several years. Accordingly, consistently with the purpose of Section 456, respondent should be permitted to prove at trial what portion of its income was attributable to its discovery of Dramamine and Banthine.

## IV.

In the alternative, respondent's income from Dramamine and Banthine constituted a special class of abnormal income under the last sentence of Section 456(a)(2) and the regulation. Instead of being precluded by summary judgment, respondent should be given an opportunity to show that it was reasonable and appropriate to treat the income from these break-through drugs as a separate class of abnormal income within the purview of those provisions.

## ARGUMENT

### I. THE ORDINARY MEANING OF THE WORD DISCOVERY INCLUDES THE DISCOVERY OF NEW DRUGS.

The Government claimed in earlier stages of this litigation that the common meaning of "discovery" is limited to the finding of something already in existence, *i.e.*, the uncovering of mineral deposits. Although this argument does not seem to be seriously advanced here (Br. 5), respondent will show that the term discovery, in everyday parlance, includes the discovery of new drugs as well as coal, oil, gas, and so forth.

The word "discovery" has been applied to new chemical compounds of medical value in more than one judicial opinion. For example, in *Smith, Kline & French Laboratories* v. *Clark & Clark*, 157 F. 2d 725 (C.A. 3, 1946), certiorari denied, 329 U.S. 796, the court was considering a certain salt called amphetamine sulphate, a novel compound which was allegedly of great importance in the treatment of various diseases. The court noted that the inventor Alles was attempting "to find a useful drug for treating allergic diseases whereby he *discovered* amphetamine sulphate, . . . That Alles' contribution was of great therapeutic use and value may not be doubted. Following his *discovery*, physicians had at hand a drug which could affect, even create, mood. Alles' *discovery* is close to pioneer invention."[2] 157 F. 2d at p. 729.

Another similar instance of the use of the term "discovery" in its ordinary sense may be found in *Wisconsin Alumni Research Foundation* v. *George A. Breon & Co.*, 85 F. 2d 166 (C.A. 8, 1936), in which the court applied the following language to a vital new drug (at pp. 167, 171):

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2. Emphasis throughout this brief is added unless otherwise indicated.

"The valuable feature of the *discovery*, and the thing that is claimed to be new and novel, consists in the combined or coacting use of the salts of copper and iron to build up the hemoglobin content of the blood.

• • • • •

"It never occurred to any of the authors of the publications in evidence that the remedy for which they were in search, namely, to increase the hemoglobin count, was to be found in some combination of inorganic iron (not alimentary) and copper in definite proportions. How, then, could their writings anticipate such a *discovery* made many years later?"

The usual or common meaning of discovery is also revealed by a newspaper editorial[3] commenting on the Kefauver Committee's investigation of the price of drugs. The editor referred to contributions by the pharmaceutical manufacturers "of great importance to the *discovery* of new remedies."

". . . This year the drug industry is laying out 200 million dollars in the hope that from this large expenditure in the laboratories some useful *discoveries* will come.

"There is no guarantee that any return will be reaped and no certainty that if something is *discovered*, some better remedy will not replace it long before the original cost is recovered."

The editorial next quotes from a speech by the president of one of respondent's competitors:

". . . I challenge soviet communism to do a better job than United States capitalism of *discovering*, developing, producing, and distributing new and effective drugs to alleviate the diseases that plague mankind.

• • • • •

3. Chicago Tribune, December 10, 1959, p. 24, col. 1.

> "In the 42 years since their October Revolution, soviet science and technology have been unable to come up with a single major drug *discovery*. . . ."

In contrast, the editorial stated that men in the free world had been able "to *discover*, to produce and to use new weapons of life for the common good of mankind." Throughout the Kefauver Committee hearings themselves, break-through drugs were also termed discoveries.

The dictionary definition of "discovery" is not limited to the discovery of natural resources whose existence and utility are already known. Webster gives as the first meaning of discovery the "finding out or ascertaining something previously unknown or unrecognized; as Curie's *discovery* of radium" (New International Dictionary [Unabridged 2d ed.] p. 745; emphasis in original). When Congress was considering the Korean War Excess Profits Tax Act, which is the statute involved here, certain drugs responsible for radical changes in the field of medicine were described at the hearing as discoveries. "The *discovery* or development of another aureomycin or another ACTH or of a cure for cancer during the taxable year must be encouraged and not penalized." Hearings before the Senate Finance Committee on H. R. 9827, 81st Cong., 2d Sess. (1950), p. 709. Similarly Dr. Hans Selye, the noted physician and professor of medicine, has written of the "discovery" of penicillin and insulin.[4] And as respondent's proposed evidence at the trial would show, contemporary newspaper articles and medical literature described both Dramamine and Banthine as "discoveries".

For the sake of brevity, just one more example of the ordinary understanding of discovery will be cited. A recent

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4. Selye, "What Makes Basic Research Basic?", *Saturday Evening Post*, January 24, 1959, pp. 30, 79-80.

article in a popular magazine notes that "the setting of our lives is being changed by *discoveries* in medicine." The author complains that "most people never see science as it is practiced. They never see the pains, the care, the patience, the bewilderment, the long hours. . . . Most people see nothing but the finished *discovery*, dispassionate and neutral." The author also comments: "If we ask a scientist to decide himself whether to withhold or to disclose a *discovery* we are asking him to flout the rights of the community."[5] Obviously this usage of discovery has nothing to do with the discovery of an oil well or the like.

The question whether or not respondent's drugs, Dramamine and Banthine, were discoveries within the commonly accepted meaning of the word is a factual issue not before this Court, since this case involves only the propriety of the summary judgment granted to petitioners by the district court. The foregoing discussion demonstrates, however, that the word discovery, as generally used, does encompass the discovery of new drugs and therefore summary judgment was improper.

## II. THE WORD DISCOVERY SHOULD BE GIVEN ITS ORDINARY MEANING.

### A. If Congress Had Intended to Give a Special Meaning to Discovery It Would Have So Specified.

In the absence of clear indications of contrary intent, words in statutes must be given their ordinary meaning. In *United States Gypsum Co.* v. *United States*, 253 F.2d 738 (C.A. 7, 1958), acq. Rev. Rul. 58-593, the Government contended that the word "stone" in the Internal Revenue Code of 1939 was intended "to denote a particular and limited class of materials which are customarily used in the

5. Bronowski, "A Moral for an Age of Plenty," *Saturday Evening Post*, November 12, 1960, pp. 24-25.

construction industry for their physical properties, and commonly designated 'stone' by persons in that industry" (p. 741). The court of appeals rejected the argument and held that stone must be given its normal broad meaning:

> "It is well established that in interpreting the meaning to be given words used in legislative enactments the words are to be given their known and ordinary signification. The obvious, plain and rational meaning is preferable to a narrow, strained, or hidden meaning." (253 F.2d at p. 744.)

Similarly, in *Quartzite Stone Co.*, 30 T.C. 511 (1958), affirmed, 273 F.2d 738 (C.A. 10, 1959), the Commissioner contended that a mineral was not quartzite within the 15% depletion allowance provisions of the Internal Revenue Code unless it was of sufficient purity to be used as a refractory material. In rejecting this contention the Tax Court said:

> ". . . Since Congress did not see fit to place any restrictions on the term 'quartzite,' it is necessary for us to determine only whether or not petitioner's deposits are quartzite within the commonly understood commercial meaning of the term." (30 T.C. at p. 516.)[6]

In *Avery* v. *Commissioner*, 292 U.S. 210, this Court held that the "ordinary meaning" of a word used in the Revenue Acts of 1924 and 1928 was controlling, because "unless Congress has definitely indicated an intention that the words should be construed otherwise, we must apply them according to their usual acceptation." 292 U.S. at p. 214. *United States* v. *Merchants National Bank*, 261 F.2d 570 (C.A. 5, 1958), a case involving a provision of the estate tax in the Internal Revenue Code of 1939, also applied the

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6. See also *South Jersey Sand Co.* v. *Commissioner*, 267 F.2d 591 (C.A. 3, 1959); *Blue Ridge Stone Corporation* v. *United States*, 170 F. Supp. 569, 572, 573 (W.D.Va., 1959).

principle that "words should, as a rule, be given their ordinary and normal meaning." And in *Commissioner v. Marshall's Estate,* 203 F.2d 534, 537 (C.A.3, 1953), the court held, in construing another provision of the 1939 Code, that "words used in a statute must be considered to have been used by Congress in consonance with the common acceptance of the meaning of such words."

The reason for this rule is that if any special limitations on the meaning of a word were intended, Congress would have expressly so provided. As noted by the court of appeals in affirming the *Quartzite* decision, *supra,* p. 14, "had Congress intended to limit quartzite by quality, a more restricted term would have been used in describing the mineral." 273 F.2d at p. 739.

So here, if Congress had intended to limit the normal meaning of "discovery" it would have restricted the term specifically. Since it failed to do so, the word must be given its commonly understood meaning rather than the peculiar, limited meaning suggested by the Government. Certainly Congress was aware of the common meaning of the word "discovery" discussed above; and if it had felt that "discovery" of minerals was more deserving of relief legislation than a "discovery" of vital importance to the health of millions of individuals, it would have so stated.

### B. Neither the Context Nor the History of Section 456(a)(2)(B) Indicates That Discovery Should Be Given a Special, Restricted Meaning.

1. *The use of "discovery" in other statutes does not show that it applies only to natural resources here.* None of the reasons advanced by petitioners for restricting the ordinary meaning of discovery in Section 456(a)(2)(B) of the Korean War Excess Profits Tax Act is persuasive. First, the Government argues that because discovery is

used with reference only to natural resources in certain other statutory provisions; the word should be similarly limited here. This argument is based chiefly on two examples, Section 105 and Section 114(b)(2) of the Internal Revenue Code of 1939 and the predecessors of those Sections in earlier revenue acts[7] (Br. 18-37, 54). Section 105 imposed a ceiling on the tax on sales of oil or gas property the value of which was demonstrated by "discovery" work by the taxpayer. This provision expressly refers to "a sale of any *oil or gas property.*" Similarly Section 114(b)(2) stated that "in the case of *mines* . . . discovered by the taxpayer" the basis for depletion should be the value at the date of discovery. In both instances Congress made it clear that the term discovery meant only the discovery of mineral deposits by adding such words as "oil or gas" or "mines." No such limitations are contained in Section 456. It is also highly significant that unlike the headings of the statutory provisions on which petitioners rely (Br. 1a, 5a, 6a, 7a, 21a, 22a, 23a, 32a, 44a), neither Section 456 nor Section 721, its 1940 precursor, contains any heading showing that their applicability was confined to the natural resources industries (see Govt. Br. 24a-28a, 37a-40a). For these reasons, petitioners' extensive treatment of Sections 105 and 114(b)(2) is really irrelevant.

In *Wong Kam Wo* v. *Dulles*, 236 F.2d 622 (C.A.9, 1956), the court considered whether a law which conferred citizenship by birth on children of a citizen was a "naturalization" law within the meaning of the Hawaii Organic Act. The Government there pointed out that in two other statutes dealing with the subject of nationality the word "naturalization" was used in the sense of conferring citizen-

7. Section 105 corresponds to Section 632 of the 1954 Code (26 U.S.C. §632). There is no provision in the 1954 Code comparable to Section 114(b)(2).

ship on a person *after* birth. But the court refused to infer a similar restriction in the term as used in the statute at issue:

> "We are not persuaded that the use of an expressly restrictive statutory definition of 'naturalization' in the 1940 and 1952 enactments indicates that a similar, but unexpressed, restriction was intended in the 1900 [Hawaii Organic] act. . . . It would have been as easy in 1909 as it was forty years later to use express language in giving the term a narrow meaning, if such had been the intention." 236 F.2d at p. 625.

An argument like petitioners' was made by a taxpayer and rejected by this Court in *Helvering* v. *Stockholms Enskilda Bank*, 293 U.S. 84. The question there was whether interest on a tax refund was interest on an "interest-bearing obligation" within the meaning of Section 217(a) of the Revenue Act of 1926. The taxpayer pointed out that "obligations of the United States" as used in Section 213(b)(4) of the same act had been held to be limited to indebtedness incurred under the borrowing power of the Government, and argued that the narrow construction of "obligation" in the latter Section indicated a restrictive meaning in the former. The Court, however, analyzed the different purposes of the two provisions and concluded that "the intent of Congress . . . is fulfilled by giving the phrase a construction within the narrow purposes of §213(b)(4); and, in the other case, by a [broader] construction . . . which will effect the obviously different statutory aim of §217(a)." 293 U. S. at pp. 87-88.

As respondent shall presently show (*infra*, pp. 34-40), the construction of "discovery" in Section 456 adopted by the court below is in keeping with the purpose of that Section. Therefore, the fact that the word "discovery" is used in a narrower sense in other provisions with different

purposes, where a restrictive interpretation is expressly indicated, does not require the adoption of a narrow meaning in Section 456 where no limitation is stated or intended. Petitioners try to equate the terms used in the income and excess profits taxes by citing Section 728 of the World War II Act (Br. 55). They fail to state that Section 728 was not reenacted in the Korean War statute at issue here.

Moreover, other federal statutes and the Constitution use the term "discovery" where the word is obviously not limited to the discovery of mineral resources. For example, the Atomic Energy Act gives the Atomic Energy Commission power to make awards to "any person making an invention or discovery useful in the production or utilization of special nuclear material or atomic energy." Section 157(b)(3); 42 U.S.C. §2187(b)(3). See also United States Constitution, Article I, Section 8, Clause 8; Tennessee Valley Authority Act, Section 5(i) (16 U.S.C. §831(d)(4)); Mutual Security Act, Section 517(a)(1) (22 U.S.C. §1668(a)(1)); and Patent Code, Section 101 (35 U.S.C. §101).

On the other hand, when Congress was dealing with expenses attributable to the "discovery" of mineral resources it did not choose to describe these as expenditures for "discovery." In Section 23(ff) of the Internal Revenue Code of 1939, taxpayers were given the option to deduct expenses "paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral . . . prior to the beginning of the development stage of the mine or deposit." If the phrase "exploration, discovery, and prospecting" in Section 456(a)(2)(B) of the Internal Revenue Code of 1939 had the well-established limited meaning which petitioners claim, why did Congress not just use this phrase and grant a deduction in Section 23(ff) for expendi-

tures for exploration, discovery, or prospecting? In fact, Congress used none of these words but rather spelled out with particularity its intention to cover only those expenses relating to the uncovering of mineral resources.

2. *Noscitur a sociis is inapplicable.* A second argument advanced by petitioners is based on the old maxim of statutory construction *noscitur a sociis.* Since, it is said, the word "discovery" is associated with "exploration" and "prospecting," the term should be limited to the discovery of natural resources (Br. 6, 14-15). This was the principal reason for the limited scope given to Section 456(a)(2)(B) by the Court of Appeals for the First Circuit in the *Polaroid* case, No. 169 present Term. Starting with the assumption that since there are different types of discovery "some interpretation is called for," the court relied on the fact that the word was associated with terms sometimes identified with the mining industry. 278 F.2d at p. 151-152. A similar argument was rejected by this Court in *Russell Co.* v. *United States*, 261 U.S. 514. The question in that case was whether a statute empowering the President "to modify, suspend, cancel or requisition any existing or future contract" could be applied to a contract with the Government. The petitioner argued that the word "contract" which, standing by itself, might refer both to private and to governmental contracts, should be limited to the former, because "contract" was associated with the word "requisition." Petitioner

> "pointed out that the power to 'requisition' cannot apply to a governmental contract; and this may be conceded, since the Government cannot requisition what it already has. Then it is said that inasmuch as the application of the word 'requisition' must be confined to private contracts, the other words associated with it must be likewise restricted by virtue of the maxim *Noscitur a sociis.* That a word may be known

> by the company it keeps is, however, not an invariable rule, for the word may have a character of its own not to be submerged by its association." 261 U.S. at p. 519.

The Court then held the maxim inappropriate since it was "invoked not to remove an obscurity but to import one." *Id.* at 520. The statute was held to cover both private and governmental contracts, since such an interpretation "accords with the broad purposes of the legislation." *Id.* at 521. So in the present case discovery as ordinarily used refers both to mineral resources and to new drugs. To assume that only one meaning must be chosen by resort to the associated words is to "import" rather than to "remove an obscurity," since the statute can and should be applied to both sorts of discovery in appropriate cases in accordance with its basic purpose. Respondent concedes that Section 456(a)(2)(B) can be applied to the mining industry, but it does not follow that *only* the discovery of mineral deposits is within the statute. As this Court said in the *Russell* case, "the contention here is not that the power in question extends to private contracts but that it is limited to them. This cannot be conceded." *Id.* at 520.

The Government relied unsuccessfully on *noscitur a sociis* in *Wong Kam Wo* v. *Dulles*, 236 F.2d 622 (C.A.9, 1956). The question in that case, as we have noted, was whether a statute which conferred citizenship by birth was covered by the Hawaii Organic Act which applied to "naturalization under the laws of the United States," and provided that in certain instances "the requirement of a previous declaration of intention to become a citizen of the United States and to renounce former allegiance" was unnecessary. Since this requirement relates only to the obtaining of citizenship after birth, the Government argued that the word "naturalization" must be restricted accordingly. The court held, however, that:

> "While the application of this principle [*noscitur a sociis*] tends to support appellee's construction of the statute in question, we regard it as inconclusive. It seems unlikely that Congress would have depended upon the application of such a principle rather than express language, had it intended to restrict the established constitutional meaning of a word." 236 F.2d at p. 626.

In *Helvering* v. *Stockholms Enskilda Bank*, 293 U.S. 84, this Court refused to limit the meaning of a word by reason of associated words in a tax statute. The question in the case was whether interest on a tax refund paid to a foreign corporation was "income from sources within the United States," which was defined to include "interest on bonds, notes, or other interest-bearing obligations." The taxpayer argued that the word obligations "must be assimilated to the particular words 'notes and bonds,' and restricted to obligations of the same kind." 293 U.S. at p. 89. The Court held that to apply such a restriction because of the word association would be contrary to the purpose of the statute. "Plainly, the payment in question constitutes income derived from a source within the United States; and the natural aim of Congress would be to reach it." *Ibid.* So also in the present case the whole statutory provision must be considered as well as the immediately adjacent words. Respondent's income from Dramamine and Banthine would be shown at trial to constitute abnormal income attributable in part to prior years. The aim of Congress in Section 456 to give relief to such income would be frustrated by holding that "discovery" must be limited by the words "exploring" and "prospecting" in subparagraph (a)(2)(B).

Thus a word of broad and general meaning should not be given a restricted interpretation just because it is combined with words of more limited application. 2 Sutherland, Statutory Construction (3d ed.) §4908 at pp. 393-394. This

is particularly true here, for the history of Section 456 (a)(2)(B) indicates that association of "discovery" with "exploration" and "prospecting" is not of any significance. "Discovery" was associated with these two words *and* such other categories as research, development, patents, formulae and other processes, or any combination of them, in the 1940 predecessor statute. Specifically, the provision at issue in the present case was derived from Section 721(a)(2)(C) of the World War II Excess Profits Tax Law, which covered "income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes." Thus the words "exploration" and "prospecting" were also in the former statute, but relief under Section 721(a)(2)(C) was not limited to mining operations. *E.g., W. B. Knight Machinery Co.*, 6 T.C. 519 (1946); *Rochester Button Co.*, 7 T.C. 529 (1946); *Keystone Brass Works*, 12 T.C. 618 (1949); *Ramsey Accessories Mfg. Corp.*, 10 T.C. 482 (1948). In modifying Section 721 in 1950, Congress did not provide that discovery relief was suddenly to be confined to natural resources. The same combination of "exploration, prospecting, and discovery" appeared even earlier in the Senate amendment to what ultimately became Section 327(d), the comparable relief provision of the Revenue Act of 1918. Although as finally enacted Section 327(d) referred generally to "abnormal conditions" which worked "an exceptional hardship" on the taxpayer, the history of the provision shows that Congress intended to include, as one instance of the abnormal conditions warranting relief, income derived from "prospecting or exploration and discovery work done by the taxpayer." See Internal Revenue Solicitor's Law Opinion 1090 (1922-I-1 Cum. Bull. 383, 386-388). A corporation which had spent large amounts "in experimental and discovery work" to develop a secret formula for the manufacture of a product, was held to qualify under Section 327. *Ibid.* Thus

"discovery" under the 1918 statute's relief for abnormal income was not restricted to oil, coal and gas, etc. Congress gave no indication when it used the very same combination of "exploration, discovery, and prospecting" in Section 456(a)(2)(B) that the associated words were henceforth to apply only to income from the discovery of mineral resources. Moreover, the wording of the statute is such that each word is given an independent significance. The language used is "exploration, discovery or prospecting *or* any combination of the foregoing." Petitioners' construction, on the other hand, would mean that discovery is covered *only* when in combination with exploration and prospecting in mining operations.

3. *The legislative history of Section 456 does not support petitioners' view.* Petitioners also seek support for limiting the scope of discovery in the legislative history of Section 456(a)(2)(B). Petitioners assert that Section 337 of the excess profits title of the Revenue Act of 1918, which was worded very much like Section 105 of the 1939 Code, *supra*, p. 16, was the ancestor of Section 456(a)(2)(B) (Br. 28). No explanation is suggested, however, for the absence of any reference to oil or gas in Section 456(a)(2)(B), such as appears in Section 337. The Committee reports and Congressional discussion of Section 456 do not indicate any connection between that provision and Section 337, much less do they show that Section 456(a)(2)(B) was just a new version of Section 337 "expanded to cover the gradual sale of the wasting asset" (Br. 28). It would be equally plausible to infer that in Section 456, Section 337 was "expanded to cover" the discovery of new drugs by the omission of the language about the sale of oil or gas property.

Section 456, however, did not stem from any "expansion" of Section 337. The two Sections work in entirely different ways. Section 337 placed an automatic 20% ceiling on the tax on the profit from sale. Under Section 456

income from discovery does not *per se* qualify for any relief; the income must also be shown to be abnormal and attributable to prior years, in which case the tax is recomputed accordingly. Section 456 appears rather to derive from Section 327(d), the provision giving relief in abnormal situations under the 1918 Excess Profits Tax. Although the term discovery was omitted in favor of more general language in the final version of Section 327(d), discovery income was intended to be included as one of the "abnormal conditions" qualifying for relief. Relief under Section 327(d) was not limited to the discovery of mineral resources. See, *supra*, p. 22.

Petitioners also rely on the elimination of the words "research and development" which were in Section 721 of the World War II Act (Br. 65-67, 73). The district court's summary judgment for petitioners was based on the idea that respondent's drug discoveries were "products arising out of research and development and as such specifically prohibited by Congress from being considered discoveries within the meaning of Section 456(a)(2)(B)" (R. 43-44).

The position taken by the district court was originally advanced by the Treasury Department in its proposed regulation on the subject, published in the Federal Register on December 4, 1952 (17 F.R. 10973). This proposed regulation stated:

> "Income from the sale of tangible property, however, even though such income may arise out of research and development which has extended over a period of more than 12 months is not income to which Section 456 is applicable. Such income from the sale of tangible property may not constitute or be included in any class of income for purposes of Section 456(b)."

This proposed regulation was abandoned after protests in favor of the one finally adopted which takes the oppo-

site position. The last sentence of the present regulation, which the Government has omitted from its quotation (Br. 18, note 16), states that "section 456 is applicable to such income [from research and development] if the income is properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)" (Treasury Regulations 130, Sec. 40.456-2(b), *supra*, pp. 3-4). The present regulation interprets the statute correctly.

The fact that the words research and development were eliminated from the statute does not mean that every form of income which can be encompassed by these words is thereby excluded from coverage. Congress nowhere stated that products "arising out of research and development" could not constitute discoveries, and the regulation as finally adopted so permits.

Respondent does not contend that income can qualify under Section 456 simply because it arises from research and development. But, as the regulation acknowledges, the elimination of these words was intended only to eliminate these broad terms, not to disqualify all income which happened also to be the product of research and development. The elimination of these words should not affect the meaning of discovery in Section 456. In *Gemsco, Inc.* v. *Walling*, 324 U.S. 244, this Court held that the Wage and Hour Administrator had power under the Fair Labor Standards Act to prohibit home work. Even though "the Senate bill contained * * * a parenthetical clause which expressly included homework among other specified practices the Administrator was authorized to restrict or prohibit, and this clause was omitted from the final conference draft" (324 U.S. at pp. 260-261), it was nonetheless held that the Administrator could prohibit homework when necessary to enforce the minimum wage provisions of the

statute. See also *United States* v. *Radio Corporation of America*, 358 U.S. 334; *Jefferson* v. *United States*, 178 F.2d 518 (C.A. 4, 1949), affirmed *sub nom. Feres* v. *United States*, 340 U.S. 135.

Research is a much wider concept than discovery. The contrast between research and invention or discovery was noted in *United States* v. *Dubilier Condenser Corporation*, 49 F.2d 306 (D.Del. 1931), affirmed, 59 F.2d 381 (C.A.3, 1932), affirmed, 289 U.S. 178, in which the court said:

> "While invention may and usually does presuppose research, research certainly does not usually involve or result in invention. To say that a person engaged in 'research' work is necessarily engaged in 'inventive work' is putting an unwarranted construction upon the word 'research' not justified by common knowledge or experience." (49 F.2d at p. 312.)

It is common knowledge that major companies have "research" departments which are constantly studying public opinion, introducing slight improvements in existing products, or experimenting with new processes. In fact it is arguable that most income of manufacturing corporations can in some way be attributed to "research and development." See, *e.g.*, *Crowell-Collier Publishing Co.*, 25 T.C. 1268 (1956); *L. E. Carpenter & Co.*, 29 T.C. 562 (1957). Therefore, inclusion of the words research and development threatened to create a major loophole in the administration of the tax. S. Rep. No. 2679, 81st Cong., 2d Sess. (1950) (1951-1 Cum. Bull. 240, 249). No such problem is presented by genuine discovery, which is a rare phenomenon. Even under Section 721 of the World War II Act, recoveries were modest, so that any "loophole" was at best potential (Govt. Br. 48; 67, note 58). Thus the Government's claim that millions of dollars in revenues would be jeopardized by the holding below is unwarranted (cf. Pet. 7).

Under the World War II Excess Profits Tax Law, income developed by "research" did not need to result from the discovery of a new product, but could qualify if the research involved only an improvement on an existing product or process. See, *e.g.*, *Keystone Brass Works*, 12 T.C. 618 (1949); *W. B. Knight Machinery Co.*, 6 T.C. 519 (1946). It proved administratively difficult in such cases to determine the extent and nature of any abnormal income from research since the claimed abnormal income had to be compared with income from similar previously existing products. Any increased income from an improvement might be attributable to increased demand for the basic product rather than to any improvement brought about by research. With a discovery these difficulties are eliminated. Income from the new product can be specifically identified and segregated and no previous similar income can be confused with sales of the new product. Thus the reasons for eliminating the classification of research and development do not exist with respect to a discovery.

The broad meaning commonly given to research and development which Congress sought to avoid by eliminating these words from the statute should not be reapplied in reverse by ruling, as did the district court, that *no* income in this wide category can come within the statute. Such a large exception is contrary to the Treasury Regulations, frustrates the intent of Congress and ignores the common distinction between research and discovery.

The history of a related provision of the World War II Excess Profits Tax Law reveals that if Congress had chosen to limit Section 456(a)(2)(B) to mining operations it would not have done so merely by eliminating the words research and development, etc. Section 711(b)(1)(I) of the World War II law governed the treatment of certain abnormal expenses in computing income during the base period. As

originally written, this Section closely paralleled the language of Section 721(a)(2)(C), *supra*, p. 22. The first version would have excluded "any deductions in connection with exploration, discovery, prospecting, research or development of tangible property, patents, formulae, processes or any combination of the foregoing." In conference it was decided to limit the exclusion to abnormal deductions in the base period for "costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, and for development costs in the case of mines." 86 Cong. Rec. 12957-12958. In other words, when Congress wished to confine the special treatment of certain abnormal expenses to those incurred by taxpayers engaged in mining or in drilling for natural resources, it did not just confine the relief to deductions attributable to "exploration, discovery or prospecting," with the idea that these words related only to minerals. Rather the legislators made the intended limitation clear by express language. Yet petitioners would have us believe that Congress accomplished the same limitation with respect to abnormal income from discovery when it modified the same combination of words in an entirely different manner in Section 456(a)(2)(B).

Nothing in the committee reports or Congressional debates indicates that Section 456(a)(2)(B) was intended to be a special benefit only for the mining or oil and gas industry. It is true, as petitioners have pointed out, that certain references were made to mining in the Senate discussions of Section 721 in 1940 (Br. 52, note 50). But other taxpayers were also mentioned. In the same discussion on which petitioners rely it was also said of Section 721(a)(2)(C):

> "Protection is afforded under the relief provisions of the bill which permits promoters, developers, or

inventors to go back and apportion over several years what they have accumulated in earnings." 86 Cong. Rec. 12175. See also *id.* at p. 12176.

The quotations from the Joint and Senate Hearings on which the Government relies (Br. 51-52) do not appear to relate to Section 721. In any event, references to mining operations in Congressional debates, when considered in context, do not justify the conclusion that Section 456 was meant to apply only in that situation. See *Russell* v. *United States*, 261 U.S. 514, 522-523.

Neither the committee reports in 1940 relating to Section 721 nor the reports and Congressional debates in 1950 discussing Section 456 make any mention of the mining industry. The language used with regard to these provisions strongly negates the idea that they were for the special benefit of any one industry. Section 721 was introduced by the Senate in 1940. The Senate Report begins its description of the Section as follows:

> "The House bill contained a number of *special relief provisions*, generally in the form of adjustments in arriving at the excess profits net income. To these your committee has added further adjustments to take care of some *unusual cases of hardship*. . . .
>
> "*In addition*, your committee has provided a relief provision *of much wider and more general application*." S. Rep. No. 2114, 76th Cong., 3d Sess., 1940-2 Cum. Bull. pp. 528, 533.

This relief provision of "wider and more general" application, as distinguished from a "special" provision for an "unusual" case, was the predecessor to Section 456. Section 456 itself was viewed in the same light in the committee reports on the 1950 Act. The provisions of the Korean

War statute were discussed *seriatim* under several general headings in both the House and Senate reports. Section 456 was discussed as part of group III "MAJOR PROVISIONS OF GENERAL APPLICATION." H. Rep. No. 3142, 81st Cong., 2d Sess., 1951-1 Cum. Bull. pp. 188-204 (Section 456 is discussed at page 195); S. Rep. No. 2679, 81st Cong. 2d Sess., 1951-1 Cum. Bull. pp. 241-259 (Section 456 is covered at p. 249). As we have noted, no mention is made in either report of oil, gas or any other minerals in connection with Section 456, much less is there any hint that this "major provision of general application" was intended to benefit only that one industry.

There were special provisions for limited groups of taxpayers in the Korean War statute. In the Committee reports these Sections were treated separately under item IV, "OTHER IMPORTANT PROVISIONS." (House Report pp. 204-208. Senate Report, pp. 259-267.) Included under this heading were Sections relating to regulated utilities, foreign corporations, personal service companies, and so forth. Special provisions for taxpayers engaged in mining were discussed together (House Report p. 205; Senate Report, pp. 261-262). These particular benefits included the exemption of income from mining specified "strategic minerals," the exemption of income attributable to excess output of mining and timber operations and from natural gas properties, and the exclusion of subsidies paid by the Government to encourage mining of critical minerals. If Congress had looked upon Section 456(a)(2)(B) as being in the same category of special benefits for taxpayers in the oil, gas and mining industry, the Committee Reports would have included it in this discussion rather than under the heading of major provisions of general application. The special relief provisions for natural resources in the World War II Act were also discussed separately in the Commit-

tee Reports of 1941 and 1942, cited by petitioners, and were not in any way "coordinated with" Section 721(a)(2)(C), as petitioners assert (Br. 54).

Another instance where Congress made its meaning explicit when it wished to give special relief to a particular industry was in a provision permitting a carryover of unused excess-profits tax credit for taxpayers, "80 per cent or more of whose gross income is derived from processing, canning, or otherwise preparing for market any seasonal fruit or vegetable or any fish or other marine life." Both the language of the proposed Section 721(b) and the Senate Committee's discussion made it clear that the carryover was "available only to corporations" so particularly described. S. Rep. No. 2114, 76th Cong., 3d Sess. (1940-2 Cum. Bull. pp. 533, 540.) On the floor of the Senate this provision was expanded to include taxpayers 80% of whose income came "from mining or processing minerals." 86 Cong. Rec. 12181. The entire subsection was later eliminated in conference. 86 Cong. Rec. 12959. The brief history of this proposal adds further evidence that if Congress had wished to limit relief under the abnormal income provisions to certain taxpayers it would have so stated in the statute itself and in its legislative history.

4. *The reference to patents in Section 456(a)(2)(C) does not preclude recovery here under Section 456(a)(2)(B).* Another line of reasoning used by the court of appeals in the *Polaroid* case but only briefly mentioned by petitioners (Br. 16-17) is based on Section 456(a)(2)(C), which lists "income from the sale of patents, formulae, or processes" as one of the classes of abnormal income. The First Circuit thought that discovery must not be interpreted to cover patentable discoveries lest it overlap subparagraph (C). (278 F.2d at p. 153.) This assumes that the categories listed in the four subparagraphs of Section 456 were meant to be mutually exclusive. But the draftsmen of the statute

understood that income might be "classifiable in more than one of such subparagraphs," in which case they provided that such income "shall be classified under the one which the taxpayer irrevocably elects." *Supra*, p. 3. Therefore the fact that income from discovery might in certain instances also be classified as income from the sale of a patent presents no obstacle to giving discovery its normal meaning.

The relief expressly accorded to the sale of a patent was not intended to exclude income from the exploitation of a discovery by a taxpayer which uses its own discovery.[8] The First Circuit's metaphor about holes in fences for various size cats is a restatement of the venerable maxim *expressio unius est exclusio alterius*, a rule of construction which this Court has frequently refused to apply. See *United States* v. *Barnes*, 222 U.S. 513; *Springer* v. *Philippine Islands*, 277 U.S. 189; *Neuberger* v. *Commissioner*, 311 U.S. 83. In *Securities and Exchange Commission* v. *C. M. Joiner Corp.*, 320 U.S. 344, this Court held that under all the circumstances of the case before it, the sale of certain oil leases fell within the scope of the Securities Act of 1933. The respondent argued that its sales could not be covered because they were of mineral rights on particular parcels of land:

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8. The court in the *Polaroid* case expressed concern that periodic income from patent royalties might be given relief under a broad construction of subparagraph (B), whereas the provision in subparagraph (C) for the sale of patents was thought to imply an exclusion of such income. 278 F.2d at p. 153. But special treatment for the sale of patents under income tax laws applies even though the seller's remuneration is payable periodically over a long term or is contingent on future productivity under the patent. See 26 U.S.C. §1235(a); *Commissioner* v. *Hopkinson*, 126 F.2d 406 (C.A. 2, 1942). Congress did not, therefore, by providing in subparagraph (C) for the "sale" of patents mean to confine relief to the case where a single lump sum payment is made in one year. Petitioners even concede this (Br. 11, note 10).

> "It is urged that because the definition mentions 'fractional undivided interest in oil, gas or other mineral rights' it excludes sales of leasehold subdivisions by parcels." (320 U.S. at p. 352.)

The Court held, however, that by using this specific phrase the draftsmen had not "thereby immunized other forms of contracts and offerings which are proved *as matter of fact* to answer to such descriptive terms as 'investment contracts' and 'securities.'" 320 U.S. at p. 352. The Court said that rules of construction such as *expressio unius est exclusio alterius* "have long been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose." *Id.* at p. 350. The purpose of the Securities Act was held to require regulation of the sale of all devices "if it proved *as matter of fact* that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts.'" *Id.* at p. 351. In the present case, respondent should not be foreclosed by summary judgment from proving as a matter of fact that its income from Dramamine and Banthine arose under circumstances which qualified it as "discovery" income within the meaning and purpose of Section 456. See *infra*, pp. 34-40.

In *Bland* v. *Commissioner*, 102 F. 2d 157 (C. A. 7, 1939), certiorari denied, 308 U.S. 563, the salary of a judge appointed to the United States Court of Customs Appeals in 1923 was held to be taxable as income from "salaries" under Section 22(a) of the Revenue Act of 1932, even though the same Section also expressly provided that "in the case of . . . judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income." By the same reasoning, respondent's income from "discovery" should

not be barred from relief under Section 456 because this income was not derived from the "sale of a patent."

Use of the *expressio unius* rule by the First Circuit in interpreting Section 456 ignores the manner in which the provision is meant to operate. The fundamental purpose of Section 456 is not to give automatic relief to the listed categories of income as such. Income falling within one of the listed categories is not qualified for special treatment unless it is proved to be abnormal in kind or amount for the particular taxpayer in the taxable year and can be proved to be attributable to prior years. Pursuant to the last sentence of Section 456(a)(2), income not in one of the specifically named classes of subparagraphs (A) through (D) can still qualify for relief subject to regulations if it meets the other tests of the statute. The specific categories listed in (A)-(D) are designed to classify income for the purpose of determining abnormality under Section 456(a)(1) rather than to grant or confine relief to the items listed. A taxpayer whose principal business is the discovery and sale of new products could not ordinarily qualify under subparagraph (B) since his income though from discovery would not be abnormal under Section 456(a)(1). But if in a particular year he sold one of his patents, the profit from such sale considered separately under subparagraph (C) might meet the abnormality tests of Section 456(a)(1). On the other hand a taxpayer who normally sells commonly marketed products might earn abnormal income from a new, original discovery which was the product of several prior years' effort. This is essentially what respondent did, as can be proved at trial.

### III. THE PURPOSE OF SECTION 456 IS FULFILLED BY THE DECISION OF THE COURT BELOW.

Respondent does not rely solely on the ordinary meaning of the word discovery and on the absence of any express

limitation in the statute or its legislative history, which might indicate that relief was confined to taxpayers in the oil and gas industry. Respondent's claim is also supported by a consideration of the purpose of the Korean War Excess Profits Tax Act as a whole and of Section 456 in particular. The main objective of the excess profits tax was to tax profits attributable to the large military budget and a profitable wartime economy. As the House Report stated:

> "One of the main objectives in imposing an excess profits tax is to reach corporate profits which have been swollen by the increased tempo of the economy. An excess profits tax selects for additional tax those corporations whose profits are higher than they probably would have been in the absence of hostilities and a large military budget." H. Rep. No. 3142, 81st Cong., 2d Sess. (1950) (1951-1 Cum. Bull. at p. 187). See also S. Rep. No. 2679, *id.*, at p. 241.

In providing relief in exceptional situations such as those covered by Section 456, Congress recognized that in some instances high profits would not be attributable to military spending or to generally higher wartime economy. Section 456, like its predecessor in World War II, was designed to take this into account:

> "Congress anticipated that business for many taxpayers would improve because of external changes and it intended the tax to apply in those cases. It also realized that there might be some instances in which the income of the base period years might not satisfactorily reflect internal changes in the business. That is, there might be cases in which the increase in profits of the tax year over those of the base years might be attributed, at least in part, to internal changes and development of a particular business or some phase of that business to its full stature and to that extent would not be attributable to the outside business stimulus." *Soabar Company*, 7 T.C. 89, 96 (1946).

Unless Searle's discoveries fall under Section 456(a)(2), the coincidence that the discovery of Dramamine and Banthine occurred shortly before the outbreak of the Korean War would operate to penalize respondent in a way which Congress did not intend. These drugs had nothing to do with the war nor were their sales attributable to the war-time economy. Respondent's discoveries, because they were new and useful advances in medicine, would have resulted in abnormal income to their discoverer in peace-time as well. This income was the result of "internal changes and development of a particular business" ( 7 T.C. at p. 96); it was not a case of income "swollen by the increased tempo of the economy" as a whole (1951-1 Cum. Bull. at p. 187).

Moreover, the discovery of these drugs resulted from years of effort and expense which were brought to fruition during the excess profits tax period. The competitive advantage of a new drug discovery lasts only a short time. Recognizing the unfairness of bunching for heavy taxation in one year income which is in fact attributable to several years, Congress intended that such abnormal income if it can be shown to be attributable to other years, should be taxed accordingly. All respondent seeks is an opportunity to prove that this income was in fact attributable to other years and is therefore entitled to relief.

Finally, by including the word "discovery" in Section 456 (a)(2)(B), Congress intended to modify an excessive tax burden which would impair incentive to discover new products for industrial progress. Surely the desire to encourage invention is no less when medical science is advanced by the discovery of new drugs.

Petitioners do not appear to dispute the fact that the granting of relief with respect to respondent's drug discoveries would be in accordance with the general purpose of Section 456. But, while conceding that respondent's

claim may be meritorious, petitioners suggest as a countervailing consideration that the Korean War Act and Section 456 in particular were designed to replace the "discretionary" and "subjective" relief provisions of the prior law with provisions permitting a "mathematical or 'automatic' relief formula." (Br. 11.) Respondent does not consider that any of the subparagraphs (A) to (D) permit such a formula. Such objective computation is said to be possible only if discovery is limited to natural resources where income attributable to discovery can be "mathematically computed" on the basis of the "discovery value" of mines. (Br. 12). If Congress had had this alleged distinction between the discovery of mines and the discovery of new products in mind, some mention of it would appear in the discussion of Section 456 in the Committee Reports, but it does not.

In any event, the distinction is highly questionable. It is often hard to decide whether or not a particular mine or well constitutes a discovery. In considering whether a coal mine was a "discovery" within the meaning of the predecessor of Section 114(b)(2) of the 1939 Code, the Board of Tax Appeals said that "no arbitrary rule as to what will constitute a sufficient discovery can be stated which will govern in all cases. * * * And hence whether a discovery has been made is a question of fact . . ." *Clarence D. Robinson*, 8 B.T.A. 778, 782-83 (1927). In *Smith* v. *United States*, 52-2 CCH U.S. Tax Cases ¶ 9402 (S.D. Iowa), the District Court had to resolve a conflict in expert testimony as to whether or not plaintiffs' limestone quarry was a "discovery." See also *Arrel* v. *Gentsch*, 52 F.Supp. 635 (N.D. Ohio, 1943).

Even if a mineral deposit is classified as a discovery, complicated factual issues requiring exercise of subjective judgment are raised by the determination of "discovery value." In *R. L. Wheelock*, 28 B.T.A. 611 (1933), the Board of Tax Appeals had to choose among estimates ranging

between $184,000 and $425,000 in guessing the discovery value of an oil lease. In *H. A. Allen*, 7 B.T.A. 1256, 1273-74 (1927), the evidence as to value varied from $750,000 to $2,000,000. Depletion based on discovery value was ultimately limited to mines because of the "very difficult" administrative problem of determining the discovery value of oil and gas wells. See S. Rep. No. 52, 69th Cong., 1st Sess., 1939-1 Cum. Bull. (Part 2) pp. 332, 345; H. Conference Rep. No. 356, *id.*, at p. 362. Further problems are raised by the 12-month period in Section 456(a)(2)(B), which requires a determination of when "discovery" ends and "exploitation" begins. Revenue Ruling 236 (1953-2 Cum. Bull. 236) states that one must carefully distinguish between "that development" of oil and gas property which "is the equivalent of 'exploration' and 'discovery'" and "that 'development'" which "is the equivalent of 'exploitation,'" since the latter "development" does not come under the statute. Such a hair-splitting distinction does not lend itself to strict objective application, nor does the Ruling "suggest any criteria for determining" how to differentiate these types of development. Cf. Govt. Br. 17. Moreover, Revenue Ruling 236 does not support petitioners' contention that Section 456(a)(2)(B) applies only to natural resources. The heading of this ruling shows that it covers the "Application of Section 456 of the Internal Revenue Code to the oil and gas extractive industry." The ruling in no way indicates that Section 456 was intended to apply *only* to the oil and gas extractive industry. In fact, the heading itself implies that the Section also applies to other industries. Obviously this 1953 ruling does not discuss other industries where discovery occurs unaccompanied by exploration or prospecting, and the Treasury has subsequently granted relief to a drug under Section 456(a)(2)(B) by settling a claim thereunder involving an antibiotic of one of Searle's competitors.

Even with the unwritten limitation on "discovery" which petitioners seek to read into the statute, Section 456 (a)(2)(B) does not permit an "objective computation" or the "automatic application" of mathematical formulas. On the other hand, the administrative problems presented by applying the statute to discoveries in the ordinary sense of the word do not appear difficult. In the *Polaroid* case the taxpayer and the Government were able to stipulate the amount of the tax-saving involved under the taxpayer's claim. See 278 F.2d at p. 150. In the present case, respondent will have the burden of proving at trial what portion of its income was attributable to the discovery of Dramamine and Banthine. The Government, without allowing respondent to present its evidence, asks this Court to assume that segregating respondent's abnormal income will be virtually impossible. Such an argument seems a singularly inappropriate reason for summary judgment.

Admittedly if Section 456(a)(2)(B) is only for taxpayers engaged in the business of searching for mineral deposits, respondent would not qualify under that provision. But summary judgment should not be granted when it requires the decision of an important novel question of law with an inadequate factual background. *Eccles* v. *People's Bank*, 333 U.S. 426; *Arenas* v. *United States*, 322 U.S. 419; *Kennedy* v. *Silas Mason Co.*, 334 U.S. 249. The present case for the first time raises the question of the meaning of the word "discovery" in Section 456(a)(2)(B).[9] The decision of the court of appeals, which would allow respondent to prove at trial that it had earned abnormal income attributable to prior years resulting from a discovery rather than from the increased tempo of war-time economy, is fully in accord with the purpose of Section 456.

---

9. *Specialties, Inc.* v. *United States*, 174 F. Supp. 89 (E.D.N.Y., 1959) did not involve Section 456(a)(2)(B) or the last sentence of Section 456(a)(2) and is not contrary to respondent's view (cf. Govt. Br. 15, note 14; 66, note 57).

Petitioners assert that respondent's construction of the statute would require courts to make an unduly difficult distinction between "real inventions" and "mere improvements" (Br. 17; see also 278 F.2d at p. 152). But such a distinction is no more nebulous than that necessary under Section 443 which requires a "substantial" change in a taxpayer's products as opposed to a "mere improvement or change in style." Treas. Reg. 130, Sec. 40.443-2. Section 435(e) also involves drawing a line between a new product and "a modification of an old product" or "improvement". Treas. Reg. 130, Sec. 40-435-3(e).

Petitioner's suggestion that respondent should look to Sections 443, 444 and 435(e) for relief rather than to Section 456 is unwarranted (Br. 65). Those Sections were designed to cover different situations. None of them accords relief to a taxpayer who earns abnormal income in one year which resulted from effort and expense in prior years to which part of the income should be attributed. One could just as plausibly argue that taxpayers engaged in mining are not under Section 456(a)(2)(B) because Congress contemplated they would look to such Sections as 450 and 453 for relief instead!

## IV. IN THE ALTERNATIVE, RESPONDENT'S INCOME FROM DRAMAMINE AND BANTHINE CONSTITUTED A SPECIAL CLASS OF ABNORMAL INCOME UNDER SECTION 456(a)(2) OF THE EXCESS PROFITS TAX ACT OF 1950.

Even should this Court hold that the term "discovery" in Section 456(a)(2)(B) does not encompass the discovery of Dramamine and Banthine, respondent would still be entitled to relief. The income from these drugs constitutes a separate class of income in respondent's business which can be shown to meet the abnormality test of Section 456(a)(1) for the taxable years in question.[10] The last sentence of Section 456(a)(2) makes it clear that income does

10. This alternative contention was presented to but not passed on by the court of appeals (R. 53). Since this issue may be reached by this Court in the *Polaroid* case, respondent has covered it here.

not have to qualify under subparagraphs (A) through (D) to be treated as abnormal. It provides:

> "The classification of income from any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

The applicable regulation under this sentence, Treasury Regulations 130, Section 40.456-2(b), provides as follows:

> "Other income, not within a class described in subparagraphs (A)-(D) of Section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of Section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. * * *"

Thus income not described by subparagraphs (A) through (D) may be grouped in classes for measuring abnormality provided that the classification is *reasonable* and *appropriate* in view of taxpayer's business and accounting experience. Respondent's income from Dramamine and Banthine was sufficiently unlike its income from other sources that this separate classification was reasonable and appropriate. Respondent expects to show at trial that its income from Dramamine and Banthine can properly be classified separately from its income from other products. These drugs were completely new in concept and successfully performed functions not previously performed by earlier pharmaceutical products. None of the other drugs marketed by Searle was a new discovery. Whereas the Government rejected Searle's claim for refund of World War II excess profits taxes because Searle had at that time no new products (R. 29-38), the examining officer in the present case concluded that Dramamine was a new discovery (R. 29). Respondent would also show that its income from these two drugs was abnormal in amount in the taxable years within the requirements of Section 456(a)

(1), and was attributable to prior years under Section 456 (b).

This Court need not decide whether respondent's proposed evidence would sustain its assertion of the distinctiveness of Dramamine and Banthine and justify the reasonableness and appropriateness of the separate classification of the income from these drugs; these are genuine issues of material fact which preclude the granting of summary judgment. The district court did not consider whether respondent's classification was reasonable or appropriate because it erroneously held that Searle's income could not qualify since it resulted from research. Therefore the reasonableness and appropriateness of respondent's classification have not yet been argued or considered, nor can they be until all relevant facts are brought forth at trial. Summary judgment on this issue of fact was improper.

Although the court of appeals in the present case found it unnecessary to consider respondent's alternative ground for relief (R. 53), the First Circuit in the *Polaroid* case rejected the taxpayer's comparable claim under the last sentence of Section 456(a)(2). The court held that the Commissioner had discretion to accept or deny unlisted classifications. Since Treasury Regulations 130, §40.456-2 (b) makes classification "subject to approval," failure to obtain such approval was held fatal to the taxpayer's cas This interpretation of the Commissioner's role under Section 456(a)(2) is squarely opposed to the Government's claim, also accepted by the First Circuit, that Congress wished to avoid "the introduction of a large degree of administrative discretion" in Section 456. 278 F.2d at p. 454. Petitioners argue that "discovery" must be given a special meaning in order to limit administrative discretion, yet at the same time they say the Commissioner's discretion in passing on taxpayers' classifications under Section 456 (a)(2) is unlimited! Petitioners assert that the last sentence of Section 456 (a)(2) "merely grants the Secretary

authority to designate such additional classes of abnormal income as he may consider appropriate" (Br. 68). However, this cannot be true because the Secretary has never designated any such additional classes but rather has promulgated the regulation setting forth rules whereby the taxpayer may designate special classes of income, if reasonable and appropriate. Since the taxpayer's classifications must be reasonable and appropriate to qualify, the petitioners' assertion that under respondent's view "income of any class must be considered 'abnormal' if it meets the quantitative test" (Br. 68) is unjustified.

The First Circuit also held that the only allowable classes under Section 456(a)(2) are those which are "similar" to the ones specified in subparagraphs (A) through (D). This qualification appears in the regulation but not in the statute. If "similar" is construed to mean that a class must be virtually identical to one of those specified in (A) through (D), the last sentence of Section 456(a)(2) would be rendered meaningless. On the other hand, if a taxpayer classifies separately a readily identifiable segment of income, outside the scope of his other operations and attributable to prior years, such a class would be "similar" to the classes specified and accordingly should qualify for relief provided the other tests of the statute and regulations are satisfied.

It is true that income from research and development may not constitute a class of abnormal income as such. Respondent, however, did not place its income from Dramamine and Banthine in the category of income from research and development. In fact while all respondent's products entailed some research, Dramamine and Banthine are unique among respondent's drugs in that they are new discoveries. The very basis of respondent's claim is that these drugs were different from its ordinary products of research. The fact that these discoveries involved some

prior research does not bar them from relief, as the last sentence of Treasury Regulation 130, Section 40.456-2(b) makes clear. See *supra*, p. 4.

The Government's assertion that the last sentence of this regulation means only that income is not excluded if it qualifies "under a class *listed* in Section 456(a)(2)" is erroneous (Br. 69). The sentence applies to any class of income to which the principle of Section 456 "is applicable", whether or not the class is one of those listed in subparagraphs (A)-(D).

## CONCLUSION

The district court's holding that all income attributable to research is *ipso facto* excluded under Section 456 was erroneous. Therefore, the judgment of the court of appeals should be affirmed and respondent should be given an opportunity to prove that Dramamine and Banthine were discoveries within the meaning of Section 456(a)(2)(B), or, in the alternative, that the income from these drugs was abnormal under the last sentence of Section 456(a)(2).

Respectfully submitted,

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Nos. 151 and 169

# In the Supreme Court of the United States

OCTOBER TERM, 1960

JOHN T. JARECKI, FORMER COLLECTOR OF INTERNAL REVENUE, ET AL., PETITIONERS

*v.*

G. D. SEARLE & CO.

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

POLAROID CORPORATION, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT*

## REPLY BRIEF FOR THE PETITIONER IN NO. 151 AND FOR THE RESPONDENT IN NO. 169

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## CITATIONS


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# In the Supreme Court of the United States

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*v.*

COMMISSIONER OF INTERNAL REVENUE

---

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT*

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**REPLY BRIEF FOR THE PETITIONER IN NO. 151 AND FOR THE RESPONDENT IN NO. 169**

---

The main question in these cases is whether the taxpayers' income from inventions can qualify as income from "discovery" within the meaning of § 456 (a)(2)(B), a question dealt with at length in our

opening brief in No. 151 and on which no further comment is necessary. Both taxpayers, however, make an alternative argument that, even if none of their income can qualify as "discovery" income within subparagraph (B), they are nevertheless entitled to relief under the last sentence of § 456(a)(2). Searle Br. 40–44; Polaroid Br. 27–33. The purpose of this brief is to answer that alternative argument in more detail than was done in our opening brief.

The question is what, if any, kinds of income other than the four enumerated classes can qualify as "abnormal income" as defined in § 456(a). The language of the section directly relevant to that question is:

> (a) *Definitions.*—For the purposes of this section—
>
> (1) *Abnormal income.*—The term "abnormal income" means income of any class described in paragraph (2) includible in the gross income of the taxpayer * * * if * * * the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years * * *.
>
> (2) *Separate classes of income.*—Each of of the following subparagraphs shall be held to describe a separate class of income:
>
> (A) * * * [awards, judgments, or decrees]; or
>
> (B) * * * [exploration, discovery, or prospecting]; or

(C) * * * [sale of patents, formulae, or processes]; or

(D) * * * [change of accounting methods].

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

The basic contention of taxpayers is that, by virtue of the last sentence, the definition of "abnormal income" is not limited to the enumerated classes but potentially includes *all* items of income of whatever nature. The argument, in substance, is that every item of income necessarily belongs to some "class" and that the only discretion given the Secretary by the last sentence is over the grouping—*i.e.*, which items of income belong together in one class and which belong in another. Once the allocation of the items to their proper classes is accomplished, however, it follows, say the taxpayers, that any class, whatever its nature, can qualify as "abnormal income" provided only that it exceeds 115% of the prior four-year average of income of that class.

Reading the last sentence of paragraph (2) by itself, taxpayers' claim that it provides for the "classification" of all income is superficially plausible. The difficulty is that there is nothing in that sentence, or elsewhere in the section, to say that all income which is "classified" is eligible to qualify as "abnormal income". To the contrary, we will show (1) that, read-

ing the section literally, that sentence provides for a "classification" that has no operative effect and is mere surplusage and (2) that it was included in the statute only by inadvertence. Alternatively, we will show (3) that if the sentence is to be given any effect at all it must be given a much more limited effect than taxpayers claim in order to reconcile it with other action taken by Congress.

## I

### READ LITERALLY, THE LAST SENTENCE OF SECTION 456(a)(2) PROVIDES FOR A CLASSIFICATION THAT HAS NO OPERATIVE EFFECT

The first sentence of § 456(a)(1) limits the definition of abnormal income to "income of any class *described in paragraph (2)*." Paragraph (2) then provides that subparagraphs (A) to (D) "shall be held to *describe* a separate class of income." After the enumeration, there follows the provision that "The classification of income of any class *not described* in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

Reading those several provisions literally, the last sentence has no operative effect. The definition of abnormal income in paragraph (1) applies only to the classes of income which are "described" in paragraph (2). The last sentence of paragraph (2) does not "describe" any class of income but rather permits the "classification" of classes "not described" in that paragraph. Hence, while the last sentence provides for the "classification" of undescribed income, there

is no operative provision to attach any consequences to that "classification." The last sentence, in short, provide for a classification which is of no consequence.

While ordinarily a statute should be read, if possible, so as to give effect to each provision, that rule of construction cannot resolve the dilemma posed by § 456(a). The reason is that the taxpayers' reading of the last sentence as meaning that *all* kinds of income are not only to be "classified" but are impliedly made eligible to qualify as "abnormal income" (subject only to the quantitative test) would equally deny any effect to a provision of paragraph (1)—namely, the phrase, "described in paragraph (2)." Under taxpayers' interpretation, paragraph (1) would mean exactly the same thing as it would if that phrase were deleted and it read:

> The term "abnormal income" means income of any class ~~described in paragraph (2)~~ includible in the gross income of the taxpayer * * * if * * * the amount of such income of such class [exceeds 115% of the four-year average] * * *.

That is, if paragraph (2) is interpreted as "describing", by virtue of the last sentence, *all* classes of income, the limitation of paragraph (1) to the classes "described in paragraph (2)" serves no function whatever.

## II

### THE LEGISLATIVE HISTORY SHOWS THAT THE LAST SENTENCE OF SECTION 456(a)(2) WAS INCLUDED BY INADVERTENCE

The origin of the last sentence of § 456(a)(2) can be best shown by tracing the development of that section from its counterpart, § 721, in the World War II law.

1. As originally enacted in 1940, § 721 was explicitly limited in application to six enumerated classes of income.[1] In the 1941 amendments (55 Stat. 17), which generally liberalized the relief provisions, § 721 was cast in a new form. It retained the six enumerated classes as "separate" classes of income to which the section applied, but also authorized relief for other classes. The form, it will be seen, was identical to that of § 456(a), except that paragraph (1) of § 721(a) did not include the phrase "described in paragraph (2)":

> (a) *Definitions.*—For the purposes of this section—
>
> (1) *Abnormal income.*—The term "abnormal income" means income of any class includible in the gross income of the taxpayer

---

[1] Section 721 of the original Act, 54 Stat. 974, provided:

> If there is includible in the gross income of the taxpayer for any taxable year an item of income of any one or more of the following classes:
>
> * * * [(a)-(f) omitted];
>
> and * * * the item includible in the gross income of the taxable year is grossly disproportionate to the gross income of the same class in the four previous taxable years, then [the amount attributable to other years may be reallocated to those years] * * *.

> * * * if * * * the amount of such income of such class [exceeds 125% ] of the prior four-year average] * * *.
>
> (2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:
>
> * * * [(A)–(F) omitted].
>
> * * * The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.

In that statute, the last sentence of paragraph (2) performed an obvious and necessary function. Unlike § 456(a)(1), § 721(a)(1) did not limit the qualifying classes of income to those "described in paragraph (2)"; rather, it defined "abnormal income" as meaning "income of any class includible in the gross income of the taxpayer" which met the quantitative test—in short, any and all classes of income. That definition made it necessary to provide for the classification of *all* income into separate classes (the particular grouping of income into classes being of obvious importance in the application of the quantitative test separately to each class). That, in turn, was the function of pargaraph (2): it enumerated six "separate" classes of income and left to regulations the "classification" (*i.e.*, grouping) of all other items of income.

The breadth of § 721(a), it may be seen, did not derive (as Polaroid claims, Br. 28) from the last sentence of paragraph (2), but from the broad definition of "abnormal income" in paragraph (1). Paragraph (2), as its heading states, was but a defini-

tion of what constitutes "separate classes of income." It was solely and exclusively a "classification" provision, governing the accounting breakdown of a taxpayer's income into its constituent "classes." Once the income was grouped into its proper classes, the function of paragraph (2) was at an end, and which, if any, of those classes were eligible to qualify as "abnormal income" depended entirely upon the definition of *that term* in paragraph (1). The breadth of § 721(a) thus derived solely from the fact that *paragraph (1)* defined "abnormal income" as including "income of *any* class," without limitation, which met the quantitative test. The last sentence of paragraph (2) was merely an accounting provision made necessary by that definition.

We may note that the comprehensive definition of "abnormal income" in § 721(a) did not mean that any income which met the quantitative test was entitled to relief. The operative relief provision was § 721(b), which granted relief only to that part of any "abnormal income" which was "attributable" to other years. The effect of the definition of "abnormal income" was to impose solely a quantitative test in qualifying income as "abnormal", while leaving to the attribution requirements of subsection (b) the function of limiting relief to the appropriate *kinds* of income. The net result, which the committee reports show was precisely

what was intended,[2] was that any kind of income which was abnormal in amount and was in fact attributable to other years was eligible for relief under § 721 of the World War II law.

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[2] H. Rep. 146, 77th Cong., 1st Sess., pp. 3, 9–10; S. Rep. 75, 77th Cong., 1st Sess., pp. 3, 10:

> Existing law provides for adjustments with respect to six specific classes of abnormal income received during the taxable years subject to the excess-profits tax. These specific items were allowed to be spread over the years to which they are actually attributable. Your committee feel that the relief afforded by this provision should not be limited to these specific items but should be available also with respect to any item of abnormal income as such income is defined in the bill.
>
> * * * * *
>
> Section 721 of the present law provides relief with respect to certain abnormalities in income in the taxable period. These abnormalities, six in number, are specifically described. * * * It is believed advisable to extend the principle of this section to any abnormal item of income. As the types of abnormal income that may occur cannot be predicted in advance, adequate relief can only be granted by thus extending the scope of this section.
>
> The test of whether an item is abnormal is clarified to provide expressly that if the item includible in the gross income of the taxable year is in excess of 125 percent of the average amount of the gross income of the same class for the 4 previous years it shall be considered abnormal. * * * The mere fact that an item includible in the gross income of the taxpayer is * * * in excess of 125 percent of the average amount of the gross income of the same class for the test period, does not result in the exclusion of such item from excess-profits net income. It is necessary that the item be found attributable to other taxable years. Consequently, if an increase in business renders an item of income in excess of 125 percent of the income for the test period, the increase in business will not result in such increased income being excluded from excess-profits net income.

That is also, of course, the very effect that taxpayers would attribute to the successor provision in the Korean War law, § 456. We will show, however, that § 456 contained a very significant change from the terms of § 721.

2. As it was reported by the House committee and passed by the House, paragraph (1) of § 456(a) (there numbered § 454) of the Korean War bill (H.R. 9827, 81st Cong.) was identical to paragraph (1) of § 721 of the World War II law, except that the quantitative test was reduced from 125% of the four-year average to 115%. Thus "abnormal income" was still comprehensively defined as "income of any class includible in * * * gross income" which met the quantitative test. The opening and closing sentences of paragraph (2) were also the same, and the only change was in the enumerated classes, which were changed to read as they do in the law as finally passed. Most of the changes in the enumerated classes, moreover, simply reflected the addition of special provisions elsewhere in the act to deal with the specific items of income removed from those classes. The only substantive change was in the substitution of subparagraphs (B) and (C) of § 456(a)(2) for subparagraph (C) of § 721(a)(2). Old subparagraph (C) had defined as a separate class of income:

> (C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes * * *;

New subparagraphs (B) and (C) defined as separate classes of income:

> (B) Income resulting from exploration, discovery, or prospecting * * *;

(C) Income from the sale of patents, formulae or processes * * *;[3]

Thus, "Income resulting from exploration, discovery, or prospecting" was placed in a separate class by itself, and there was removed from the enumeration entirely all "Income resulting from * * * research, or development of tangible property, patents, formulae or processes" except that arising from the sale of the patent, formula, or process itself—*i.e.*, eliminating income from the taxpayer's use or licensing of the patent, etc., or from the sale of manufactured items (*i.e.*, "tangible property") developed by the taxpayer.

The elimination of those items of income from the enumerated classes in the House bill, without changing the definition of "abnormal income" in paragraph (1), literally had little effect. Paragraph (1) still defined "abnormal income" as including "income of *any* class includible in * * * gross income" which met the quantitative test, and the items of income removed from the specifically-described classes would still be a part of *some* class of income. Thus, under the literal wording of the bill as drafted by the House committee, the only effect of the change would seem to have been to require the items taken out of the enumerated classes to be placed in a different class under the last sentence of paragraph (2) providing for the classification of "any class" of income not included in the described classes.

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[3] The omission from each of the three quoted provisions is of the phrase: "or any combination of the foregoing, extending ["developed", in the last quoted provision] over a period of more than 12 months."

The House committee reporting the bill, however, obviously thought its changes had done more than that. The committee report, after explaining the nature of the relief under § 456, stated (H. Rep. 3142, 81st Cong., 1st Sess., p. 13):

> Adjustments of this type are limited to income arising out of—
>
> 1. A claim, award, adjustment, or decree;
>
> 2. Exploration, discovery, or prospecting which extended over a period of more than 12 months;
>
> 3. The sale of patents, formulas, or processes developed over a period of more than 12 months; or
>
> 4. Income which is includible in the taxable year rather than another year by reason of a change in the taxpayer's method of accounting.
>
> The equivalent provision in the World War II law (section 721) also permitted adjustments with reference to certain other types of income, particularly that resulting from the sale of tangible property arising out of research and development which extended over a period of more than 12 months. This provision in the old law was a potential loophole of major dimensions. Because there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (sec. 722), and because the need for a reallocation of such income seemed to be materially less than in the other classes of income described above, this item has been omitted from the list of ab-

normal types of income for which a reallocation can be made under this bill.

The report thus speaks of the bill as though it limited relief to the specifically enumerated classes of income, so that the effect of the elimination of research and development income from the enumerated classes would be to make such income not eligible for relief at all. In fact, however, the bill reported by the committee and passed by the House simply did not conform to the report, for it retained both the all-inclusive definition of abnormal income (paragraph (1)) and the all-inclusive provision for the classification of income not within the enumerated classes (the last sentence of paragraph (2))—provisions identical to those adopted in the 1941 amendments to § 721 for the very purpose of expanding relief beyond the enumerated classes.

When the bill got to the Senate, the error of the House was recognized and sought to be corrected. The Senate committee adopted verbatim the House committee's *report* but amended the House *bill* so that it would have the effect attributed to it by the report. It accomplished that by two amendments, both passed by the Senate. By Amendment No. 200, it restricted the comprehensive definition of "abnormal income" in paragraph (1) by adding the phrase "described in paragraph (2)," so that it read:

> (1) *Abnormal income.*—The term "abnormal income" means income of any class *described in paragraph (2)* includible in the gross income of the taxpayer * * * if * * * the amount of such income of such class [exceeds 115% of the four-year average] * * *.

Having limited the definition of abnormal income to the described classes, there was no longer any need for the last sentence of paragraph (2) providing for the "classification" of income not included in the described classes, and that sentence was accordingly deleted by Amendment No. 201. With those corrections, the bill meant exactly what the House committee had intended it to mean—namely, that relief is available only for the four classes of income specifically described and that income from the sale of tangible property attributable to research and development activities in prior years is *not* eligible for relief.

Had the bill been adopted as amended by the Senate, there would of course be no issue in these cases. The difficulty arises from the inexplicable action taken by the conference committee, the report of which recommended to the respective Houses (H. Rep. 3231, 81st Cong., 2d Sess., p. 1):

> That the Senate recede from its amendments numbered * * * 201 * * *.
>
> That the House recede from its disagreement to the amendments of the Senate numbered * * * 200 * * *.

The conference, in short, accepted the Senate's limitation of the definition of abnormal income to the classes "described in paragraph (2)" but rejected the deletion of the last sentence of paragraph (2) providing for the "classification of income of any class *not described*" in paragraph (2). The action, it may be seen, was contradictory: the conference accepted the amendment to paragraph (1) that rendered the last sentence of paragraph (2) surplusage

but then rejected the deletion of that sentence.[4] In turn, of course, it was in the form recommended by the conference committee that the bill was finally adopted.

The only explanation that can be given for the retention of the last sentence of paragraph (2), notwithstanding the amendment of paragraph (1) in a way depriving that sentence of any operative effect, is, we believe, that it was the product of inadvertence resulting from the great speed with which the Act was drafted and passed by Congress. Under those circumstances, there is no occasion, we submit, to strain the other language of § 456(a) to give effect to that sentence. If, as we have shown above, that sentence is without operative effect upon a literal reading of the section, it can properly be treated as surplusage which found its way into the Act simply by oversight. Not only does that treatment not offend any rule of construction—since to give effect to that sentence would require denying effect to another provision (the limitation of abnormal income to the "described" classes)—but it is essential if effect is to be given to the Congressional intent as unequivocally stated in the committee reports and as manifested by

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[4] Nor is any explanation offered by the statement of the House managers, which merely includes Amendment No. 200 (to paragraph (1)) among a group described as "clerical amendments" to which the House agrees and then describes Amendment No. 201 (to paragraph (2)) as one which "relates to classes of abnormal income attributable to other taxable years" and from which the Senate recedes. H. Rep. 3231, *supra*, pp. 23, 24.

the amendment made to paragraph (1) to limit the definition of "abnormal income."[8]

In summary, we submit that the inconsistency between paragraph (1) (limiting eligibility for relief to the classes of income "described in paragraph (2)") and the last sentence of paragraph (2) (providing for the classification of *any* class of income not expressly described) should be resolved as follows: the committee reports show that both Houses of Congress intended to limit relief to the four classes of income specifically enumerated and to deny relief to income from research and development. The Senate amendment to paragraph (1) limiting its scope to the classes of income "described in paragraph (2)" would, given its literal meaning, fully accomplish that purpose, for that restriction of paragraph (1) leaves the last sentence of paragraph (2) without operative effect—while it provides for the classification of other income, the resulting "classes," not being "described in paragraph (2)", simply fail to come within the operative definition of "abnormal income" in paragraph (1). On the other hand, if effect is sought to be given to the last sentence of paragraph (2) by reading paragraph (1) as impliedly including within the definition of abnormal income not only the classes specifically

[8] We may note that Polaroid's recitation of the history of the last sentence of paragraph (2)—noting that it was stricken by the Senate and restored by the conference—simply ignores the related amendment made to paragraph (1). See Polaroid Br. 28–29. How that amendment, restricting "abnormal income" to the classes "described in paragraph (2)", can be reconciled with the all-inclusive effect it would give to the last sentence of paragraph (2), Polaroid does not undertake to explain.

"described in paragraph (2)" but also "income of any class not described" in paragraph (2) but subject to "classification" under the last sentence—in short, *all* income—the result would be to deny any effect to the addition to paragraph (1) of the phrase "described in paragraph (2)" and frustrate the purpose of Congress to restrict relief to the enumerated classes. Since either interpretation renders some part of the statute superfluous and the more literal interpretation is the one conforming to the disclosed intention of Congress, that interpretation (with abnormal income being limited to the classes "described in paragraph (2)") should be accepted. It should be recognized that the last sentence of paragraph (2) was deprived of any operative effect by the adopted amendment to paragraph (1) and was left in the statute only by oversight.

## III

### IF ANY EFFECT IS TO BE GIVEN TO THE LAST SENTENCE IT MUST BE NARROWLY CIRCUMSCRIBED TO AVOID FRUSTRATING THE CONGRESSIONAL PURPOSE

The purpose of this Point is to examine how, if it is thought to be inappropriate to give no effect to the last sentence of § 456(a)(2), some effect might be given to it while at the same time also giving some effect to the limitation of the definition of "abnormal income" in paragraph (1) to the "described" classes of income.

1. There are, as we have seen, two steps in defining "abnormal income": first, the "classification" of income into separate classes; and, second, the specification of which of those classes are "eligible" to qualify as abnormal income if they meet the quantitative test. The

last sentence of (a)(2) deals in terms only with "classification" and not with "eligibility", and, read as a "classification" provision, it seems to contemplate that all income is classifiable into some class or another. That was clearly the meaning of the same language in the World War II law, for § 721(a)(1) defined "abnormal income" as meaning "income of *any* class includible in * * * gross income" which met the quantitative test, thus making it necessary to provide in (a)(2) for the "classification" of *all* income.

In § 456(a), however, the last sentence of (a)(2) would have no effect if read as purely a "classification" provision, for there is nothing to make the income so classified *eligible* to qualify as abnormal income (*i.e.*, with the definition of abnormal income having been limited to the "described" classes of income). Hence, to give any effect to the last sentence, it must be read as an "eligibility", as well as a "classification", provision—that is, it must be read as meaning that the regulations are to govern not only the classification of the unenumerated kinds of income but also the eligibility of the additional "classes" to qualify as abnormal income.

If the last sentence of (a)(2) is to be read as an eligibility provision, however, it must necessarily be given something less than the all-inclusive scope it seems to have as a classification provision. For if it were interpreted to mean not only that all income is to be classified but that *all* of the resulting classes are eligible to qualify as abnormal income, it would deny any effect to the limitation of (a)(1) to "described" classes and frustrate the expressed purpose of Congress to restrict the scope of § 456(a). And the only way that the last

sentence can be given less than an all-inclusive scope is to read it as delegating to the Secretary the power, by regulations, to specify what additional classes of income, less than all, are eligible for relief. In short, any reconciliation of the last sentence of (a)(2) with the limitation added to (a)(1) and the legislative history requires that the Secretary be given the function, not only of "classifying" income but of determining its "eligibility" for relief.

That interpretation of the last sentence of (a)(2) appears to have been adopted by the Staff of the Joint Committee on Internal Revenue Taxation in its "Summary of * * * 'The Excess Profits Tax Act of 1950' as Agreed to by the Conferees." The staff summary, in describing the relief provided for abnormal income, states (p. 9):

> Adjustments of this type are limited to income arising out of—
>
> (1) * * * [(1) to (4), reciting the four enumerated classes, omitted]; or
>
> (5) income of other classes permitted under regulations prescribed by the Secretary.

It may be seen that the summary, although otherwise taken verbatim from the House and Senate committee reports (see pp. 12-13, *supra*), differs from them in recognizing for the first time (by the addition of paragraph (5)) the existence of the last sentence of § 456(a)(2) of the bill. It reads that sentence, however, not as meaning that *all* classes of income are eligible for relief, but as meaning only that the Secretary may "permit" certain additional classes to be added to the kinds of income to which the relief is

"limited." That is, relief is still "limited" to less than all classes of income, but the Secretary has power to add one or more classes to those described in the statute.[6]

If, however, the statute is read as delegating a power to determine the eligibility of additional classes, it is necessary to find in it some standards by which the Secretary is to exercise that power. Since none are stated, they can be found only by inference from the enumerated classes, their history, and the purpose of the relief provision as a whole. It can be inferred, first, that relief should be limited to classes of income essentially similar in nature, and in the need for allowing such an adjustment, to the four classes specifically enumerated. By that standard, for example, income from the sale of copyrights, being essentially similar—both in nature and in the policy justifications for granting relief—to that from the sale of patents, might be allowed as an additional class. Of particular importance here, however, is the clear indication found in the legislative history that income from the sale of tangible property (*i.e.*, manufactured articles) ought not be reallocated to prior years simply because research and development expenses were incurred in prior years in developing the article. That that is one kind of income that Con-

[6] That interpretation is also consistent with the statement of Senator George on the floor of the Senate that the bill, as agreed to by the conference committee, "would give the Secretary of the Treasury the *authority* to prescribe classifications in addition to those specified in the bill." 96 Cong. Rec. 16,978 (emphasis added).

gress did *not* want to be made eligible is established not only by the committee reports but by the deliberate omission of that particular kind of income from the enumerated classes otherwise taken from § 721(a) of the World War II law. That is to say, even without reliance on the committee reports, it can be inferred from a comparison of § 456 with its predecessor that Congress, in eliminating that kind of income from the enumerated classes, did not want it brought back into the statute under the power delegated to the Secretary by the last sentence.

In summary, if any effect is to be given to the last sentence of paragraph (2) it should be interpreted as at most delegating to the Secretary a discretionary power to extend relief to additional kinds of income essentially "similar" to the enumerated classes, specifically excepting, however, income from the sale of tangible property attributable to prior years solely on the basis of research and development expenditures made in the prior years.

2. To the extent that they give any effect to the last sentence of (a)(2), the regulations under § 456 give to it only the limited effect suggested above. Their significance can best be seen from their development from the corresponding regulations under § 721 of the World War II law.

Under § 721, as we have pointed out, the last sentence of (a)(2) meant what it literally said, simply providing for the classification of *all* income not within the described classes, such classification being necessary because of the definition of abnormal income in (a)(1) as including "income of any class

includible in * * * gross income." The regulations, in turn, followed that evident meaning and provided simply that (Regs. 112, § 35.721–2):

> * * * Income which does not fall within those provisions [*i.e.*, the enumerated classes] may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such other classes as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice.

That provision seems clearly to have contemplated that all income could be grouped in one class or another and that the Commissioner's review would go only to the breakdown as between classes—*i.e.*, he could disapprove the inclusion of a particular item in one class rather than in another. The regulations in no way dealt with the *eligibility* of the classes to qualify as "abnormal income," for under § 721(a)(1) "any class" was expressly made eligible.

With the change in the definition of abnormal income in § 456(a)(1) of the Korean War law, the draftsmen of the regulations were faced with a difficult problem in giving effect to the last sentence of (a)(2). Although the language of the sentence was the same as that of § 721(a)(2), it was evident that it could not be given the same effect without destroying the limitation added to § 456(a)(1), and what other effect might be given to it was, as we have shown, a question of considerable difficulty. The solution adopted seems to have been, in substance, to preserve the ambiguity of the statute as to whether any

classes other than those enumerated could qualify and to limit the additional classes, if any, to those "similar" to the enumerated classes. As first issued, the relevant provision of the regulations consisted of one sentence reading as follows (Regs. 130, § 40.456–2(b); emphasis added):

> (b) Other income, not within a class described in subparagraphs (A)–(D) of section 456(a)(2), *to which section 456 is applicable* may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes *similar to those specified* in subparagraphs (A)–(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice.

The form of the regulations, it may be seen, was borrowed from the regulations under § 721(a)(2), but with two significant additions (italicized above) the effect of which was to leave open the question whether § 456 was in fact "applicable" to any classes of income other than those enumerated and, assuming that it was "applicable" to some other income, to limit eligibility to kinds of income which were "similar" to the enumerated kinds.

On December 4, 1952, a proposed amendment to the regulations was published (17 F.R. 10973) which would have added to the original sentence the following two sentences:

> Income from the sale of tangible property, however, even though such income may arise out of research and development which has ex-

> tended over a period of more than 12 months is not income to which section 456 is applicable. Such income from the sale of tangible property accordingly may not constitute or be included in any class of income for purposes of section 456(b).

Upon protests to the proposed amendment being received and considered, the two sentences were revised and adopted (T.D. 6026, 1953–2 Cum. Bull. 235) in the following form:

> Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D).

The reasons for the change in the form of those two sentences seems apparent. As originally proposed, the amendment, by excluding income "from the sale of tangible property" from any class of income eligible under § 456, had the obviously unintended implication that income from the sale of mineral products would be excluded even though arising in part from "discovery" and thus specifically included in § 456(a)(2)(B). Additionally, of course, it would have excluded income from research and development even if it otherwise fell within one of the enumerated

classes (*e.g.*, judgment income or income includible in the taxable year because of a change in accounting methods). The revised amendment overcame those objections by making clear that such income was eligible if a part of some other class "to which [§ 456] is applicable"—*i.e.*, if it fell within one of the enumerated classes or such other additional classes, if any, brought into the section by the last sentence of (a)(2).

The important thing is that the regulations reject any implication that the last sentence of (a)(2) means that *all* classes of income are eligible. At most, the regulations extend relief only to classes of income "similar" to the enumerated classes, and even that is limited by the next sentence expressly denying relief to income from the sale of tangible property arising out of research and development. In short, the regulations, to the extent that they give effect to the last sentence of (a)(2),[7] adopt the interpretation of that sentence we have suggested above—namely, as delegating to the Secretary the power to make additional classes of income eligible for relief, the additional classes to be determined by the degree of their "similarity" to the enumerated classes, subject, however, to the specific exclusion of research and development income as an eligible class.

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[7] We may note, however, that the regulations, by carefully referring only to "Other income * * * to which section 456 is applicable," leave open the question whether § 456 is in fact "applicable" to any other income besides the enumerated classes. Hence, it would not be inconsistent with the regulations for the Court to hold, as we have previously suggested, that the last sentence of (a)(2) is surplusage and has *no* operative effect.

3. Under the foregoing interpretation of the last sentence of § 456(a)(2) and of the regulations thereunder, it is plain that neither taxpayer here is entitled to relief. Taxpayers argue that part of their income from sales of Dramamine and Banthine (Searle) or from sales of Polaroid cameras or 3-D glasses (Polaroid) is income arising from their "discovery" of those products and is thus of a nature "similar" to one of the enumerated classes (income from "discovery" of minerals), thereby qualifying it as an additional class eligible for relief under the first sentence of the regulations (§ 40.456–2(b)). We need not debate the degree of "similarity" between those classes of income, for the general standard of the first sentence of the regulations is in any event qualified by the specific provision of the second sentence expressly denying eligibility to research and development income as an additional class (*i.e.*, unless such income is a part of another class of income otherwise eligible for relief).

Plainly, the basis for taxpayers' claim for relief is that a part of their income from the sale of their patented products is "Income from the sale of tangible property arising out of research and development * * *." While the income might also be described by various other of its numerous characteristics (*e.g.*, camera income, sales income, manufacturing income), the only characteristic relevant to the claim that allowance of relief under § 456 is appropriate is that the income is attributable in part to research and

development activities occurring in prior years. The very purpose of the second sentence of the regulations is, in turn, to make clear that that characteristic of an item of income is not sufficient to qualify it for relief.

In the end, taxpayers are seeking to obtain relief under the last sentence of § 456(a)(2) for precisely the kind of income that was specifically enumerated in the World War II law (§ 721(a)(2)(C)) and specifically deleted from the enumeration in the Korean War law. Even if the last sentence of § 456(a)(2) is read as authorizing the Secretary to extend relief to some kinds of income not included in the enumerated classes, it was certainly not intended, by that means, to bring back within the statute the very kind of income which Congress deleted because of the experienced difficulties in applying the relief provisions to it. The expressed determination of the Secretary, by the regulations, that income is not eligible for relief simply because it is attributable in part to research activities in prior years is, therefore, fully consistent with the revealed Congressional purpose and hence a valid exercise of the power delegated to the Secretary to determine the eligibility of unenumerated kinds of income.

The taxpayers in these cases can ultimately prevail, therefore, only on their argument that the last sentence of § 456(a)(2) means that *all* classes of income, of whatever nature, are eligible to qualify as "abnormal income" so long as they meet the quantitative

test.[8] As we have pointed out, however, giving that effect to that sentence would deny any effect to the "described in paragraph (2)" limitation added to §456(a)(1). That would frustrate completely the purpose of Congress, unequivocally shown in the legislative history, to restrict the scope of the "abnormal income" definition and, in particular, to remove research and development income from its reach. There is no warrant for such a reading, we believe, either in the literal wording of that sentence (which provides only for the "classification" of income without prescribing the consequences of the classification) or in the history of the section. In our view, the sentence should either be recognized as surplusage and be given no effect at all, or at most be given the limited effect

[8] Even that interpretation, while it might entitle Polaroid to some relief, would probably be of no avail to Searle. Even if "abnormal income" includes any "class" of income, there still remains the question of "classification" as such—*i.e.*, the scope of the "class" to which the quantitative test is to be applied. In the case of Polaroid, it appears that it might meet the quantitative test however its total income is classified, for it might perhaps meet the test even if all of its income were grouped into a single class (*i.e.*, the broadest possible "class"). In the case of Searle, however, it appears (though the record is incomplete) that it can meet the quantitative test only if it is able to segregate its income from Dramamine and Banthine into a class separate from its income from the sale of its other ethical drugs. The only basis it suggests for segregating those items from its other drugs is that they were major "discoveries", while its development or improvement of its other products by research and development involved only, to use Searle's language, little "discoveries." That is plainly not an adequate basis for separate classification, and the Commissioner's rejection of that classification was fully within the discretion given him by the statute and regulations.

suggested in this Point, in either of which events taxpayers here cannot qualify for relief under that sentence.

Respectfully submitted.

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# TRANSCRIPT OF RECORD

## Supreme Court of the United States

OCTOBER TERM, 1960

## NO. 169

POLAROID CORPORATION, PETITIONER,

*vs.*

COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

PETITION FOR CERTIORARI FILED JUNE 23, 1960
CERTIORARI GRANTED OCTOBER 10, 1960

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[fol. 1]

# IN UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

T. C. Docket No. 65983

POLAROID CORPORATION, Petitioner,

—vs.—

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION FOR REVIEW—Dated December 14, 1959

Now comes Polaroid Corporation, the petitioner above-named, by its attorney, Isaac M. Barnett, and petitions the United States Court of Appeals for the First Circuit to review the decision of the Tax Court of the United States rendered in the above cause on November 24, 1959, ordering and deciding that there are deficiencies in income and excess profits tax of $87,935.72, $220,260.07 and $261,682.44 for the calendar years 1951, 1952 and 1953, respectively.

Petitioner avers that the Tax Court erred (i) in deciding that petitioner's income during 1951, 1952 and 1953, arising from petitioner's discovery of the Polaroid Land process did not constitute abnormal income within the intendment of Section 456 of the Internal Revenue Code of 1939; (ii) in deciding that petitioner's income during 1951, 1952 and 1953, arising from petitioner's discovery of a synthetic stereo light polarizer did not constitute abnormal income within the intendment of Section 456 of the Internal Revenue Code of 1939; (iii) in deciding that in computing petitioner's net abnormal income for 1951 under Section 456(a)(3) of the Internal Revenue Code of 1939, the [fol. 2] interest charged on the normal and surtax deficiencies were deductible from the interest credited on the overassessment of excess profits tax resulting from the settlement of petitioner's Section 722 claim for the years 1942 and 1943; and (iv) in deciding that there were deficiencies

in excess profits tax for the years 1951, 1952 and 1953, and that there was not an overpayment of excess profits tax for 1951 entitling petitioner to a refund.

This petition for review is filed pursuant to the provisions of Section 7482 and 7483 of the Internal Revenue Code of 1954.

The facts determining venue pursuant to Section 7482(b) of the Internal Revenue Code of 1954, are as follows:

Petitioner is a corporation duly organized and existing under and by virtue of the laws of the State of Delaware, with its principal office in Cambridge, Massachusetts. Petitioner filed an original return for 1951 with the Collector of Internal Revenue for the District of Massachusetts. Petitioner filed an amended return for 1951 and original returns for 1952 and 1953 with the Director of Internal Revenue, Boston, Massachusetts. The offices in which said respective returns were filed were within the jurisdiction of the Court of Appeals for the First Circuit.

Dated: December 14, 1959.

Isaac M. Barnett, Counsel for Petitioner, Office & P. O. Address, 60 West 42nd Street, New York 17, N. Y.

(Verified by Isaac M. Barnett December 14, 1959.)

[fol. 3]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 65983

POLAROID CORPORATION, Petitioner,

—vs.—

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Appearances:

For Petitioner: Isaac M. Barnett, Esq.

DOCKET ENTRIES

1957

Feb 25—Petition received and filed. Taxpayer notified. Fee Paid

Feb 27—Copy of petition served on General Counsel.

Feb 25—Request for Circuit hearing in Boston, Mass. filed by petr. Granted 3/6/57. Served 3/7/57.

April 9—Answer filed by Resp. Served 4/11/57.

1958

Oct 21—Notice of trial March 2, 1959, Boston.

[fol. 4]

1959

Mar 9-10—Trial at Boston by J. Opper. Filed at trial: Petr. trial memo; Stip. of Facts. Orig. briefs due May 11, 1959. Replies due June 10, 1959.

Mar 24—Transcript of proceedings of Mar 9-10, 1959. (2)

May 6—Brief filed by petr. S. 6/2/59.

May 8—Motion by resp. for extension of time to June 1, 1959 to file brief. Gr. 5/11/59. Served 5/12/59.

June 1—Brief filed by resp. S. 6/2/59.

June 25—Reply brief filed by petr. Served 7/8/59. (Advised resp. will not file).

Nov 23—Findings of Fact and Opinion filed. Judge Opper. Decision for resp. Served 11/23/59.

Nov 24—Decision entered. Judge Opper. Served 11/24/59.

[fol. 5]

BEFORE THE TAX COURT OF THE UNITED STATES

WASHINGTON

[Title omitted]

DECISION—Entered November 24, 1959.

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, filed November 23, 1959, it is

Ordered and Decided: That there are deficiencies in income and excess profits tax of $87,935.72, $220,260.07 and $261,682.44 for the calendar years 1951, 1952 and 1953, respectively.

Enter:

Entered Nov. 24, 1959

Clarence V. Opper, Judge.

[fol. 6]

BEFORE THE TAX COURT OF THE UNITED STATES

33 T. C. No. 33

[Title omitted]

FINDINGS AND OPINION OF TAX COURT—November 23, 1959

1. Income from the sale of tangible property resulting from research and development, *held*, not abnormal within the meaning of section 456 (a) (2) (B), I.R.C. 1939.

2. Deductible interest on 1942 and 1943 income tax deficiencies which arose out of excess profits tax relief for same years, *held*, related to interest credited on excess profits tax refund within the meaning of section 456 (a) (3), I.R.C. 1939.

Isaac M. Barnett, Esq., for the petitioner.
James E. Markham, Jr., Esq., for the respondent.

Respondent determined deficiencies in petitioner's income and excess profits tax of $87,935.72, $220,260.07 and $261,682.44 for the years 1951, 1952 and 1953, respectively. He disallowed petitioner's claim for refund of income and excess profits tax of $193,908.85 for the year 1951.

The issues to be decided are (1) whether petitioner received abnormal income within the meaning of section 456, I.R.C. 1939, during any of the years in issue from the sales of either (a) stereo products, or (b) the Polaroid Land equipment, or both; and (2) whether interest credited to petitioner on a refund of excess profits tax for the years 1942 and 1943 must be reduced by interest charged on deficiencies in income tax for those same years under section 456 (a) (3), I.R.C. 1939, in computing petitioner's "net abnormal income" for 1951.

[fol. 7] FINDINGS OF FACT

The stipulated facts are found.

Petitioner is a Delaware corporation with its principal office in Cambridge, Massachusetts. It filed an original return for 1951 with the collector of internal revenue for the district of Massachusetts. It filed an amended return for 1951 and original returns for 1952 and 1953 with the director of internal revenue, Boston, Massachusetts.

Petitioner was incorporated in 1937 and from that date to late in 1948 it engaged primarily in the business of research and development and the exploitation of research and development by manufacturing and selling a variety of optical products in the field of light polarization, such as polarizing sunglasses and visors, polarizing camera filters, polarizing day-driving visors, and variable density windows.

In 1952 and 1953, 3-dimensional (3-D) motion pictures were exhibited. The audience viewed the picture through viewers incorporating the Polaroid synthetic light polarizer which were necessary to give the 3-D illusion. Edwin H. Land, petitioner's president and director of research, invented the synthetic polarizer used in these viewers. Petitioner owned three patents which covered this polarizer, hereafter referred to as stereo. The exhibition of the 3-D motion pictures would not have been commercially

practicable had petitioner's synthetic polarizer not been available. No noninfringing material for this purpose was on the market.

Petitioner's sales of stereo products during 1946 through 1950 were:

| Year | Sales |
|---|---|
| 1946 | $25,141 |
| 1947 | 7,077 |
| 1948 | 55,867 |
| 1949 | 9,850 |
| 1950 | 15,385 |

[fol. 8] Its sales, expenses and net income from these sales in 1951, 1952 and 1953 were:

| Year | Sales | Expenses | Net income |
|---|---|---|---|
| 1951 | $ 39,543 | $ 21,726 | $ 17,817 |
| 1952 | 85,443 | 82,558 | 2,885 |
| 1953 | 6,310,201 | 4,717,671 | 1,592,530 |

The expenses incurred by petitioner in the invention and development of its stereo products during 1943 through 1953 were:

| Year | Expenses |
|---|---|
| 1943 | $ 60,695 |
| 1944 | 86,819 |
| 1945 | 172,640 |
| 1946 | 22,806 |
| 1947 | 9,040 |
| 1948 | — |
| 1949 | — |
| 1950 | 17,203 |
| 1951 | 22,773 |
| 1952 | 51,602 |
| 1953 | 143,953 |

Petitioner's income from the sales of stereo products during the years 1946 through 1953 was income from sales of tangible property arising out of research and development which extended over a period of more than 12 months.

On February 21, 1947, at a meeting of the Optical Society of America, Land first publicly announced and demonstrated his invention of a camera and photographic film which produced a finished dry positive print directly from the camera within 60 seconds after the picture was snapped. The camera and photographic film are known respectively as the Polaroid Land camera and Polaroid Land picture roll, and together they constitute the Polaroid Land equipment. The Optical Society program referred [fol. 9] to the equipment as "a new kind of photography as revolutionary as the transition from wet plates to daylight-loading film."

New basic principles of photographic processing were evolved by Land in his conception of the Polaroid Land equipment. There had never previously existed any photographic process in which a positive print was obtained simultaneously with the development of the negative by the application to the negative and positive receiving sheets of both the silver halide developer and the silver halide solvent. There had been no prior recognition of the possibility of simultaneously introducing the silver halide developer and the silver halide solvent and so controlling their intensities and speed of operation that the developer could perform its function in the presence of the solvent before the solvent could act upon the silver halide in the negative. The four separate steps in the prior art—the developing and fixing of the negative and the printing and fixing of the positive—were compressed in the Polaroid Land equipment into one step, the developing and fixing of the negative and contemporaneous formation on a positive sheet of a positive print from the dissolved silver halide of the negative. In the Polaroid Land picture roll all materials required for the developing and printing are part of the film assembly. The camera in which the film is processed remains dry throughout.

There were at least two major basic developments involved in the Polaroid Land equipment. One was a means by which high concentrations of developer and silver halide solvents were introduced simultaneously, after having been stored in a capsulating agent to keep them from oxidizing through contact with the air. The second was the process

of catalyzing the precipitation of silver from the silver halide solvent onto the surface of the positive receiving sheet in such a way as to obtain a silver image with relatively minute quantities of silver.

[fol. 10] Prior to the conception of the Polaroid Land equipment, no photographic equipment existed whereby the picture was taken, the negative developed, and a positive print obtained directly from the camera by a 1-step dry process. Land's new inventions in photographic equipment were novel.

Petitioner's first patent in its "Picture in a Minute" field issued in 1948, and at the end of 1953, 118 patents had issued and 91 additional applications were pending. At the end of 1958, 238 patents had issued and 202 additional applications were pending. In 1954, the United States Patent Office created a separate subclass to handle, exclusively, patent applications in the Polariod Land equipment field.

The Polaroid Land equipment was first marketed by petitioner in November 1948. The camera is not usable with any film other than the Polaroid Land picture roll and the picture roll is not usable with any camera other than the Polaroid Land camera. The photographic accessories marketed by petitioner, such as flash guns, light meters, filters and copy makers, have been specifically designed for the Polaroid Land camera and have had no market apart from their use with that camera. There have been no products on the market directly competitive with the Polaroid Land equipment since its introduction. In addition to its use in producing a picture in a minute, the Polaroid Land equipment is used to make instantaneous X-rays and in devices for the detection of the extent of exposure to radiation.

Petitioner's sales of Polaroid Land cameras, photographic packs, and photographic accessories during 1948 through 1950 were:

| Year | Sales |
|---|---|
| 1948 | $ 39,155 |
| 1949 | 5,379,023 |
| 1950 | 5,057,908 |

[fol. 11] Its sales, expenses and net income from these sales in 1951, 1952 and 1953 were:

| Year | Sales | Expenses | Net income |
|---|---|---|---|
| 1951 | $ 7,394,385 | $ 6,164,973 | $1,229,412 |
| 1952 | 11,076,969 | 9,611,657 | 1,465,312 |
| 1953 | 17,212,784 | 14,727,692 | 2,485,092 |

The expenses incurred by petitioner in the invention and development of Polaroid Land cameras, photographic packs, and photographic accessories during 1944 through 1953 were:

| Year | Expenses |
|---|---|
| 1944 | $ 7,150 |
| 1945 | 96,943 |
| 1946 | 388,667 |
| 1947 | 300,369 |
| 1948 | 365,332 |
| 1949 | 267,425 |
| 1950 | 267,733 |
| 1951 | 143,986 |
| 1952 | 213,776 |
| 1953 | 243,936 |

No expenses were incurred by petitioner in the invention and development of Polaroid Land cameras, photographic packs or photographic accessories prior to 1944.

The sales of the Polaroid Land equipment during the years 1948 through 1953 resulted entirely from its capacity to produce a picture in a minute. If this equipment had not made an instantaneous positive print there would have been no demand for the camera or photographic pack during that period.

Petitioner's income from the sales of the Polaroid Land equipment and photographic accessories during 1948 through 1953 was income from the sales of tangible property arising out of research and development which extended over a period of more than 12 months.

The income received by petitioner in 1951, 1952 and 1953 from the sales of stereo products and the Polaroid [fol. 12] Land equipment and accessories does not constitute abnormal income under section 456.

In 1951, petitioner's claims for relief under section 722, I.R.C. 1939, for the years 1942 and 1943 were settled, and as a result, interest of $74,864.93 on the overassessments was computed to June 13, 1951. As a further result of this settlement on the same claims, interest on deficiencies in income tax for those years of $34,075.11 was computed to June 13, 1951. The interest charged on the deficiencies in income tax for the years 1942 and 1943 in the amount of $34,075.11 is a deduction relating to the interest of $74,864.93.

## OPINION.

OPPER, *Judge:* The issues in this case are essentially questions of statutory construction. Respondent does not dispute the facts produced by petitioner.

The income[1] which petitioner contends is abnormal under section 456, I.R.C. 1939,[2] was earned by the sale of

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[1] The parties have drawn no distinction between the income earned from the sales of the Polaroid Land equipment and that earned from the sales of the stereo products. Accordingly, we treat them as being similar in nature for purposes of this issue.

[2] SEC. 456. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) Definitions.—For the purposes of this section—

(1) Abnormal Income.—The term "abnormal income" means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if * * * the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years * * *.

(2) Separate Classes of Income.—Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

[fol. 13] tangible property which arose out of research and development[3] extending over a period of more than 12 months. Respondent's regulations[4] provide that such income is not abnormal and may not constitute a class of income under section 456. This provision in respondent's regulations is squarely in accord with congressional intent as manifested by the legislative history of section 456.

Basically, the Korean War excess profits tax was patterned after the World War II excess profits tax. There was, however, a general attempt to simplify the adminis-[fol. 14] tration of the tax and to eliminate potential inequities. The World War II tax described one class of abnormal income as follows:

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(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

[3] Petitioner cannot and does not deny this, but insists that the "tangible" properties would have been valueless except for the process they embodied. This seems to us irrelevant.

[4] Regulations 130. Sec. 40.456-2. [As amended by T.D. 6026, 1953-2 C.B. 235, 236] Classification of income. • • •

(b) Other income, not within a class described in subparagraphs (A)-(D) of section 456 (a) (2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456 (a) (2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise property includible within a class of income to which such section is applicable, for example, the class described in section 456 (a) (2) (D).

SEC. 721 [I.R.C. 1939]. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) Definitions.—For the purposes of this section—

* * * * * * *

(2) Separate Classes of Income.—Each of the following subparagraphs shall be held to describe a separate class of income:

* * * * * * *

(C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; or

Congress reported with regard to the Korean War (Section 456) counterpart of this class of abnormal income:

> The equivalent provision in the World War II law (sec. 721) also permitted adjustments with reference to certain other types of income, particularly that *resulting from the sale of tangible property arising out of research and development which extended over a period of more than 12 months.* This provision in the old law was a potential loophole of major dimensions. Because there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (sec. 722), and be- [fol. 15] cause the need for a reallocation of such income seemed to be materially less than in the other classes of income described above, *this item has been omitted from the list of abnormal types of income* for which a reallocation can be made under this bill. [H. Rept. No. 3142, 81st Cong., 2d Sess. (1950), p. 13. Emphasis added.]

Petitioner contends that its income is "otherwise properly includible within a class of income to which * * * [section 456, I. R. C. 1939] is applicable" and therefore qualifies under the exception contained in the regulation. It contends that the income resulted from a "discovery" within the meaning of section 456 (a) (2) (B), and that although the term "discovery" as used in that section may not encompass all inventions it does include new basic inventions of "revolutionary proportions" such as the Polaroid Land equipment and the stereo products. For purposes of this case we assume that petitioner's inventions may have been new, startling or even revolutionary.

But Congress intentionally excluded income from the sale of property resulting from research, whether or not constituting invention, as a potential class of abnormal income when it enacted section 456, and it did so regardless of the dynamic effect of an invention. Although the meanings of the terms "discovery" and "invention" may overlap in the field of patent law, see 35 U. S. C. 100, we do not read the section before us as indicating that Congress intended the term "discovery" to include what is normally thought of as patentable inventions.[5] Cf. section [fol. 16] 456 (a) (2) (C), *supra* at footnote 2. Respondent's suggestion that "discovery" was used to refer to the gas, oil and mining industries has some merit inasmuch as it is interposed between "exploration" and "prospecting" which

[5] "Webster's New Collegiate Dictionary defines 'exploration' as '[a]ct of exploring, as for geographical discovery,' and in discussing the word 'discover' the same work says: 'Discover presupposes exploration * * *.' It also defines 'discovery' as '1. Act of discovering,' and the verb 'prospect' as '[t]o explore or examine for something.' We consider that Congress in using the words 'exploration, discovery, or prospecting' meant acts leading up to and antedating the finding of the thing discovered, which in this case, according to the hypothesis made by both parties, was the oil pool here in question. A factor leading us to this conclusion is the deliberate omission by Congress in enacting section 456 (a) (2) (B) of the word 'development,' which had appeared in the predecessor statute. We consider that Congress did not mean the words 'exploration, discovery, or prospecting' to include acts seeking information about the thing already discovered, performed as incidents to its development and exploitation after it was discovered." (*Big Four Oil & Gas Co.*, 29 T. C. 31, 41.)

are normally thought of in connection with those industries. This, however, is a question we need not decide. The narrower interpretation of section 456 is necessary if we are to give effect to the action taken by Congress in changing the language of the predecessor of that very section to exclude income resulting "from the sale of tangible property arising out of research and development which extended over a period of more than 12 months." *Searle & Co.* v. *Jarecki* (N.D. Ill.) F. Supp.

Petitioner further contends that although its income may not fall within one of the classes enumerated in section 456, it is entitled under respondent's regulations[6] to group this income in such classes "as are reasonable in a business of the type which * * * [it] conducts, and as are appropriate in the light of * * * [its] business experience and accounting practice." Although this regulation provides that such a grouping is subject to respondent's approval, petitioner contends that the provision in section 456(a)(2) that "the classification of income of any class not described * * * shall be subject to regulations prescribed by the Secretary" was intended to broaden the classes and that the respondent has no right to refuse approval to petitioner's classification. That section does not require respondent to classify [fol. 17] all income. He did not approve of petitioner's classification and, furthermore, his regulation specifically excludes the type of income in question with an exception which we have found not applicable to petitioner. Petitioner's income earned in 1951, 1952 and 1953, was not abnormal within the meaning of section 456.

The second issue is whether the interest with which petitioner was credited in 1951 upon its successful claim for an excess profits tax refund, and which was admittedly abnormal income, must be reduced in computing petitioner's net abnormal income under section 456 (a) (3)[7] by the inter-

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[6] See footnote 4, *supra*.

[7] SEC. 456. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) Definitions.—For the purpose of this section—

* * * * *

(3) Net Abnormal Income.—The term "net abnormal income" means the amount of the abnormal income less, under

est which it was charged on income tax deficiencies which were attributable to the reduced excess profits tax. In the words of the statute, the question is whether the interest on the income tax deficiency is a cost or deduction "relating" to the interest on the excess profits tax refund.

Although the corporate income tax and the excess profits tax are separate and distinct types of taxes, *Babcock & Wilcox Co.* v. *Pedrick* (C.A. 2), 212 F. 2d 645, certiorari denied 348 U. S. 936, they are related in some aspects. The net dollar return to petitioner from its excess profits tax refund claim was reduced by a corresponding income tax deficiency, because as petitioner was successfully able to reduce its adjusted excess profits net income its normal tax [fol. 18] net income increased. Section 26 (e), I.R.C. 1939, applicable to the relevant years 1942 and 1943. There was, at least to that extent, a relationship between the World War II excess profits tax and the income tax.

It is not necessary to say that income tax and excess profits tax are not different taxes in order to say that they are "related." Computation of one is reciprocal to that of the other, and it is this arithmatic relationship which led automatically and inevitably to the deficiency in income tax upon reduction of and determination of overassessment in the excess profits tax. *Morrisdale Coal Mining Co.*, 21 T.C. 393; *Ambassador Hotel Co. of Los Angeles*, 32 T.C. 208.

Interest on the one was due to the petitioner by reason of the same fact that caused interest on the other to be due from petitioner, namely, allowance of petitioner's claim under section 722. We think it would hence be totally illogical to say that the two payments are not "related." And that the interest payable by petitioner was a "deduction" cannot be questioned. Section 23 (b), I.R.C.

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regulations prescribed by the Secretary, • • • (B) an amount which bears the same ratio to the amount of any costs or deductions relating to such abnormal income, allowable in determining the normal-tax net income for the taxable year, as the excess of the amount of such abnormal income over 115 per centum of such average amount bears to the amount of such abnormal income.

1939. It need not also be a "cost." We conclude that respondent did not err on either ground urged.

Reviewed by the Court.

*Decision will be entered for the respondent.*

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[fol. 19]

BEFORE THE TAX COURT OF THE UNITED STATES

[Title omitted]

PETITION FOR REVIEW OF DEFICIENCY DETERMINATION AND OF DISALLOWANCE OF REFUND CLAIM—February 25, 1957

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau symbols ARC-Ap:BOS:EM) dated January 22, 1957, and for a review of the disallowance of petitioner's claim for refund for excess profits tax illegally, erroneously or excessively collected for the calendar year 1951, and as a basis for its petition alleges as follows:

1. Petitioner is a Delaware corporation with its principal office at 730 Main Street, Cambridge, Massachusetts. The returns for the periods here involved were filed with the District Director of Internal Revenue, Boston Division, Boston, Massachusetts.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to petitioner on January 22, 1957. The notice of disallowance of petitioner's claim for refund for the calendar year 1951 is contained in said notice of deficiency.

[fol. 20] 3. Petitioner's claim for refund for the calendar year 1951 (a copy of which is attached and marked Exhibit B) was filed with the District Director of Internal Revenue, Boston Division, Boston, Massachusetts, on or about October 1, 1953, within the period provided by the Internal Revenue Code for the filing of such refund claim. Such refund claim is based on excess profits tax abnormalities under Section 456 of the 1939 Internal Revenue Code. The

overpayment of tax for which the refund claim was filed was paid within the period applicable under Section 6512 and Section 6511(b)(2) of the Internal Revenue Code.

4. The deficiencies as determined by the Commissioner are in excess profits taxes for the calendar years 1951, 1952 and 1953, in the aggregate amount of $569,878.23, all of which is in dispute, and are itemized as follows:

| | |
|---|---|
| 1951 | $ 87,935.72 |
| 1952 | 220,260.07 |
| 1953 | 261,682.44 |

Said notice of deficiency further states that the issue raised in petitioner's claim for refund for the calendar year 1951 should be made a part of this petition. The amount of petitioner's said claim for refund is $193,908.85, all of which is also in dispute.

5. The determination of tax set forth in said notice of deficiency and the disallowance of petitioner's aforesaid claim for refund are based upon the following errors:

(a) In computing the net abnormal income of petitioner for the purpose of computing the excess profits tax liability of petitioner for the year 1951 under Section 456 of the 1939 Internal Revenue Code, the Commissioner erroneously held that the interest credited on the overassessments of excess profits tax arising out of petitioner's claims for relief under Section [fol. 21] 722 of the 1939 Internal Revenue Code for the years 1942 and 1943 in the sum of $74,864.93 should be reduced by the interest charged on the related deficiencies in income tax for said years in the sum of $34,075.11, whereas the entire amount credited as interest on the overassessments of excess profits tax constituted abnormal income under Section 456 of the 1939 Internal Revenue Code.

(b) In determining the excess profits tax liability of petitioner for the years 1951, 1952 and 1953, respectively, the Commissioner erroneously held that petitioner's income for such years, respectively, arising from its discovery of the Polaroid Land camera and

photographic pack, did not constitute abnormal income under Section 456 of the 1939 Internal Revenue Code, whereas such income did constitute abnormal income within the intendment of such section.

(c) In determining the excess profits tax liability of petitioner for the years 1951, 1952 and 1953, respectively, the Commissioner erroneously held that petitioner's income for such years, respectively, arising from its discovery of devices and techniques used in connection with the exhibition of 3-dimensional motion pictures did not constitute abnormal income under Section 456 of the 1939 Internal Revenue Code, whereas such income did constitute abnormal income within the intendment of such section.

6. The facts upon which petitioner relies as the basis of this proceeding are as follows:

(a) The interest credited to petitioner on the overassessments of excess profits tax arising out of the settlement in the year 1951 of petitioner's claim for relief under Section 722 of the 1939 Internal Revenue Code for the years 1942 and 1943 was in the aggregate sum of $74,864.93.

[fol. 22] (b) The interest charged against petitioner on the related deficiencies in income tax arising out of the settlement in the year 1951 of petitioner's claim for relief under Section 722 of the 1939 Internal Revenue Code for the years 1942 and 1943 was in the aggregate sum of $34,075.11.

(c) The entire amount of interest credited to petitioner on the aforesaid overassessments of excess profits tax constituted abnormal income within the intendment of Section 456 of the 1939 Internal Revenue Code.

(d) From the date of its incorporation in 1937 to late in 1948, petitioner was engaged primarily in the business of manufacturing and selling a variety of optical products in the field of light polarization, such

as polarizing sunglasses and visors, polarizing camera filters, polarizing day driving visors, and variable density windows.

(e) In the latter part of 1948, petitioner, after devoting many years to its invention, placed on the market an entirely new type of camera, known as the Polaroid Land camera, which produces finished photographs in one minute.

(f) The camera and the photographic pack required for its use were revolutionary inventions in that never before in the entire history of photography had a portable camera been created which enabled the user to take and produce a finished positive picture within a period of sixty seconds. The inventions were acknowledged by the scientific world as a unique discovery in the photographic field.

(g) The invention of the Polaroid Land camera and photographic pack changed the character of taxpayer's business. Since their advent, taxpayer's major operations have been primarily in the photographic field.

(h) This camera and photographic pack created a source of income theretofore never experienced by peti- [fol. 23] tioner or by any other taxpayer. Such income was directly attributable to the prior years in which the discovery and invention of these unique products were carried on by petitioner.

(i) The respective amounts of petitioner's net income during the years 1951, 1952 and 1953, respectively, resulting from the invention and discovery of the Polaroid Land camera and photographic pack were as follows:

| | |
|---|---|
| 1951 | $1,231,106 |
| 1952 | 1,452,759 |
| 1953 | 2,480,542 |

(j) The said respective amounts of petitioner's net income during the years 1951, 1952 and 1953, respectively, resulting from the invention and discovery of

the Polaroid Land camera and photographic pack constituted income resulting from discovery in a business of the type conducted by petitioner and was abnormal income within the intendment of Section 456 of the 1939 Internal Revenue Code.

(k) Petitioner, after devoting many years to their invention, discovered devices and techniques for use in connection with exhibition of 3-dimensional motion pictures.

(l) Such devices and techniques of petitioner made possible the exhibition of 3-dimensional motion pictures.

(m) Such devices and techniques created a source of income theretofore never experienced by petitioner or by any other taxpayer. Such income was directly attributable to the prior years in which the discovery and invention of these unique products occurred.

(n) The respective amounts of petitioner's net income for the calendar years 1951, 1952 and 1953, respectively, resulting from its invention and discovery of such devices and techniques for the exhibition [fol. 24] of 3-dimensional motion pictures were as follows:

| | |
|---|---|
| 1951 | $ 17,817.00 |
| 1952 | 2,885.00 |
| 1953 | 1,587,580.00 |

(o) The said respective amounts of petitioner's income during the years 1951, 1952 and 1953, respectively, resulting from the invention and discovery of devices and techniques for the exhibition of 3-dimensional motion pictures constituted income from discovery in a business of the type conducted by petitioner, and was abnormal income within the intendment of Section 456 of the 1939 Internal Revenue Code.

7. The net income of petitioner arising out of the discovery of the Polaroid Land camera and photographic pack and of the devices for the exhibition of 3-D motion pictures, subject to excess profits tax for the years 1951,

1952 and 1953, respectively, was $754,570, $982,260 and $1,865,640, respectively, as more particularly appears in the computation set forth in Exhibit C attached hereto and made part hereof.

Wherefore, petitioner prays that this Court may hear the proceeding, determine that there is no deficiency due from petitioner for the years 1951, 1952 and 1953, and allow petitioner's claim for refund for the year 1951.

Isaac M. Barnett, Counsel for Petitioner, 60 East 42nd Street, New York 17, N. Y.

Of Counsel, Silver, Saperstein & Barnett, 60 East 42nd Street, New York 17, N. Y.

(Verified by Carlton P. Fuller, February 15, 1957.)

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[fol. 25] EXHIBIT A TO PETITION

55 Tremont Street—Room 920-A

ARC-Ap:BOS
KM

APPELLATE DIVISION

REGISTERED MAIL

Jan 22 1957
Massachusetts

Polaroid Corporation
730 Main Street
Cambridge 39, Massachusetts

Gentlemen:

You are advised that the determination of your income and excess profits tax liability for the taxable years ended December 31, 1951, December 31, 1952 and December 31, 1953 discloses deficiencies in tax aggregating $569,878.23 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, WASHINGTON 4, D. C., for a redetermination of the deficiencies. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

[fol. 26] Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to this office. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours,

Russell C. Harrington
Commissioner,
By (signed) J. E. MAHONEY
Associate Chief—Appellate

Enclosures:

Statement
Form 1276
Agreement Form

KMurphy/mb
1/15/57

[fol. 27] ARC-Ap:BOS
KM

STATEMENT

POLAROID CORPORATION
730 Main Street
Cambridge 39, Massachusetts

Tax Liability for Taxable Years Ended December 31, 1951, December 31, 1952 and December 31, 1953

INCOME TAX

| Year | Liability | Assessed | Deficiency |
|---|---|---|---|
| 1951 | $ 997,377.71 | $ 909,441.99 | $ 87,935.72 |
| 1952 | 1,192,675.46 | 972,415.39 | 220,260.07 |
| 1953 | 3,291,023.24 | 3,029,340.80 | 261,682.44 |
| Totals | $5,481,076.41 | $4,911,198.18 | $569,878.23 |

In making this determination of your income tax liability, careful consideration has been given to the reports of examination dated June 30, 1954 and January 24, 1956, to your protests dated December 13, 1954 and March 30, 1956 and to the statements made at the conference held on March 6, 1956.

"It is determined that in the computation of the amount of net abnormal income for the purpose of computing the excess profits tax under Section 456 of the 1939 Internal Revenue Code for the year 1951, the interest credited on the overassessments of excess profits tax arising out of your claims for relief under Section 722 of the Internal Revenue Code of 1939 for the years 1942 and 1943 of $74,-864.93 should be reduced by the interest charged on the related deficiencies in income tax for said years of $34,-075.11.

"It is determined that the income received by you from the Polaroid Land Camera and Photographic Pack and from your invention of devices and techniques used in the [fol. 28] exhibition of 3-dimensional motion pictures does not constitute abnormal income under Section 456 of the Internal Revenue Code of 1939 in the years 1951, 1952 and 1953.

"If petition is filed with The Tax Court of the United States against the determination of the Commissioner, the issue raised in your claim for refund for the year 1951 should be made a part of the petition filed with the Court. If a petition is not filed, a statutory notice of disallowance will be forwarded to you in accordance with the provisions of Section 3772(a)(2) of the Internal Revenue Code of 1939."

A copy of this letter and statement has been mailed to your representative, Mr. Isaac M. Barnett, et al c/o Silver, Saperstein & Barnett, 60 East 42nd Street, New York 17, New York, in accordance with the authority contained in the power of attorney executed by you.

Year: 1951

SCHEDULE 1

Adjustments to Net Income

| | | |
|---|---|---|
| Net Income as disclosed by return | | $1,421,431 |
| Unallowable deductions and additional income: | | |
| (a) Massachusetts excise tax | $ 2,265.24 | |
| (b) Administrative expense | 2,515.28 | |
| (c) Legal expense | 557.65 | |
| (d) Repairs | 22,000.01 | |
| (e) Depreciation | 41,805.67 | |
| (f) Patent department expense | 23,905.20 | |
| (g) Interest Income | 40,789.82 | 133,838 |
| Total | | $1,555,270 |
| Nontaxable income and additional deductions: | | |
| (h) Amortization of patents | 4,937.21 | |
| (i) Loss on equipment abandoned | 5,175.15 | 10,112 |
| Net income adjusted | | $1,545,158 |

[fol. 29]

## SCHEDULE 1-A

### Explanation of Adjustments

| | | |
|---|---|---|
| (a) Massachusetts excise tax | | 2,265.24 |
| Amount claimed | $110,666.47 | |
| Amount allowable | 108,401.23 | |
| Adjustment | $ 2,265.24 | |
| The deduction for Massachusetts excise tax was overstated in your return. | | |
| (b) Administrative expense | | 2,515.28 |
| Amount of $2,515.28 paid on an additional Massachusetts tax for a prior year is not an allowable deduction for the current year. | | |
| (c) Legal expense | | 557.65 |
| Legal expense of $557.65 in connection with the purchase of land is a capital expenditure. | | |
| (d) Repairs | | 22,000.01 |
| Items totalling $22,000.01, charged to repairs, represent capital expenditure. Depreciation has been allowed in (e) below. | | |
| (e) Depreciation | | 41,805.67 |
| Deduction for depreciation has been decreased by $41,805.67, as follows: | | |
| Depreciation claimed on return on accounts adjusted | $123,265.22 | |
| Depreciation allowable | 81,459.55 | |
| Adjustment | $ 41,805.67 | |
| (f) Patent department expense | | 23,905.20 |
| The deduction claimed on your return for patent department expense has been decreased by $23,905.20, the amount considered a capital expenditure in connection with the prosecution of new patents. Amortization has been allowed in (h) below. | | |
| (g) Interest Income | | 40,789.82 |

[fol. 30] Your income is increased by interest income accrued as of December 31, 1951 on excess profits tax overassessments less interest due to June 13, 1951 on normal and surtax deficiencies for the years 1942 through 1945, as follows:

| | |
|---|---|
| Interest income | $ 74,864.93 |
| Interest expense | 34,075.11 |
| Net, as above | $ 40,789.82 |

(h) Amortization of patents ..... 4,937.21

Amortization is allowed in connection with patent expense capitalized in prior year examinations and in (f) above, as follows:

| Year | Amount | Estimated Life | Amortization Allowable | |
|---|---|---|---|---|
| 1948 | $27,047.62 | 17 years | $1,591.04 | |
| 1949 | 23,665.02 | | 1,392.06 | |
| 1950 | 21,267.40 | | 1,251.02 | |
| 1951 | 23,905.20 | | 703.09 | (½ year) |
| Total | | | $4,937.21 | |

(i) Loss on equipment abandoned ..... 5,175.15

Due to depreciation adjustments, the loss on equipment abandoned has been adjusted as follows:

| | |
|---|---|
| Loss claimed | $ 127.45 |
| Loss as adjusted | 5,302.60 |
| Adjustment, as above | $ 5,175.15 |

The detail is as follows:

| Dept. | Assets | Reserve Per Return | Per Return Loss on Sale or Abandonment | Reserve as Corrected | Loss as Corrected |
|---|---|---|---|---|---|
| A-52 | $ 235.00 | $ 132.18 | $102.82 | $ 133.91 | $ 101.09 |
| A-73 | 1,854.94 | 1,854.94 | none | 1,082.04 | 772.90 |
| A-72 | 25,910.74 | 25,910.74 | none | 25,771.92 | 138.82 |
| A-70 | 2,932.81 | 2,908.18 | 24.63 | 1,644.11 | 1,288.70 |
| A-74 | 4,365.21 | 4,365.21 | none | 1,364.12 | 3,001.09 |
| | Totals | | 127.45 | | 5,301.60 |

[fol. 31]

## Schedule 2

### Computation of Tax

| | |
|---|---|
| Net income adjusted | $1,545,158.16 |
| Combined normal tax and surtax (50¾ of $1,545,158.16 less $5,500.00) | 778,667.77 |
| Alternative tax (Schedule 3) | 778,324.16 |
| Excess profits tax (Schedule 5) | 219,053.55 |
| Income and excess profits tax liability | 997,377.71 |
| Tax assessed, Account No. 4180242 | 909,441.99 |
| Deficiency of income and excess profits tax | 87,935.72 |

## Schedule 3

### Alternative Tax

| | |
|---|---|
| Net income adjusted | 1,545,158.16 |
| Less: Excess of net long-term capital gain over net short-term capital loss | 1,334.37 |
| Ordinary net income | 1,543,823.79 |
| Partial tax (50¾% of $1,543,823.79 less $5,500.00) | 777,990.57 |
| Tax on capital gain (25% of $1,334.37) | 333.59 |
| Alternative tax | 778,324.16 |

## Schedule 4

### Excess Profits Net Income

| | |
|---|---|
| Excess profits net income as disclosed by return | 1,420,097.28 |
| Additions: | |
| Net adjustment to net income (Schedule 1) | 123,726.51 |
| | 1,543,823.79 |
| Deductions: | |
| Net abnormal income* | 35,440.13 |
| Excess profits net income adjusted | 1,508,383.66 |

*Net abnormal income for 1951 attributable to prior years is computed as follows:

| | |
|---|---|
| Net interest credited (Exhibit A) | $43,119.92 |
| Less: Amount attributable to 1952 | 2,330.10 |
| Amount attributable to 1951 and prior year | 40,789.82 |
| Net amount attributable to 1951 ($8,015.45 less $2,665.76) | 5,349.69 |
| Amount attributable to prior years | 35,440.13 |

[fol. 32]

## Schedule 5

### Computation of Excess Profits Tax Under Section 456, I. R. Code of 1939

| | | |
|---|---|---|
| Excess profits net income less abnormal income attributable to prior years | | $1,508,383.6 |
| Excess profits credit | | 778,205.1 |
| Adjusted excess profits net income | | 730,178.5 |
| Tax at 30% | | 219,053.5 |
| Excess profits taxes for prior years due to inclusion of net abnormal income from 1951. | | |
| 1950 (No adjusted excess profits net income) | none | |
| 1946 through 1949 | none | |
| 1945 (No adjusted excess profits net income) | none | |
| 1944 (No adjusted excess profits net income) | none | none |
| Total excess profits tax | | $ 219,053.5 |

Year: 19

## Schedule 6

### Adjustments to Net Income

| | | |
|---|---|---|
| Net income as disclosed by return | | 1,815,246.9 |
| Unallowable deductions and additional income: | | |
| (a) Capital items | | 17,914.8 |
| Total | | $1,833,161.7 |
| Nontaxable income and additional deductions: | | |
| (b) Massachusetts excise tax | $ 3,712.41 | |
| (c) Interest on tax refund | 40,789.82 | |
| (d) Depreciation | 7,634.60 | |
| (e) Depreciation | 2,112.95 | 54,249.7 |
| Net income adjusted | | $1,778,911.9 |

[fol. 33]

## SCHEDULE 6-A

### Explanation of Adjustments

(a) Capital items ..... 17,914.81

The following items charged to expense are determined to be capital expenditures:

| Date | Item | Amount |
|---|---|---|
| 8/27/52 | Office partition | $ 1,050.00 |
| 11/20/52 | Office partition | 750.00 |
| 12/31/52 | Chain fence | 860.00 |
| 6/29/52 | Frame Hood | 1,219.81 |
| 2/20/52 | Mixing tanks | 680.00 |
| 11/12/52 | Engineering & Design Negative Developing Machine | 13,355.00 |
| | | $17,914.81 |

Depreciation has been allowed in (e) below.

(b) Massachusetts excise tax ..... 3,712.41

Additional deduction for Massachusetts excise tax is allowable, as follows:

| | |
|---|---|
| Claimed on return | $137,801.46 |
| Allowable | 141,513.87 |
| Adjustment | 3,712.41 |

(c) Interest on tax refund ..... 40,789.82

Interest of $40,784.82 reported on return is eliminated from income, having been determined to be taxable in the prior taxable year.

(d) Depreciation ..... 7,634.60

Depreciation is allowed as follows:

| Kind of Property | Cost | Depreciation |
|---|---|---|
| Leasehold-Cambridge Rubber | $ 4,540.07 | $1,702.48 |
| Leasehold Kaplan-Crown Cork | 6,012.85 | 2,327.54 |
| Leasehold Kaplan-Crown Cork | 8,907.05 | 3,143.66 |
| Leasehold Main Street | 1,829.61 | 372.12 |
| Roll Film-Assembly Equipment | 710.43 | 88.80 |
| Total | $22,000.01 | $7,634.60 |

(e) Depreciation ..... $2,112.95

Depreciation is allowed for one-half year in connection with items capitalized in (a) above.

[fol. 34]

## SCHEDULE 7

### Computation of Tax

| | |
|---|---|
| Net income adjusted | $1,778,911. |
| Combined normal tax and surtax (52% of $1,778,911.93 less $5,500.00) | 919,534. |
| Alternative tax (Schedule 8) | 917,839. |
| Excess profits tax (Schedule 10) | 274,835. |
| Income and excess profits tax liability | $1,192,675. |
| Tax assessed, Account No. 4181802 | 972,415. |
| Deficiency of income and excess profits tax | $ 220,260. |

## SCHEDULE 8

### Alternative Tax

| | |
|---|---|
| Net income adjusted | $1,778,911. |
| Less: Excess of net long-term capital gain over net short-term capital loss | 6,517. |
| Ordinary net income | 1,772,394. |
| Partial tax (52% of $1,772,394.07 less $5,500.00) | 916,144. |
| Tax on capital gain (26% of $6,517.86) | 1,694. |
| Alternative tax | $ 917,839. |

## SCHEDULE 9

### Excess Profits Net Income

| | |
|---|---|
| Excess profits net income as disclosed by return | $1,808,729. |
| Less: Net adjustment to net income (Schedule 6) | 36,334. |
| Excess profits net income adjusted | $1,772,394. |

[fol. 35]

## Schedule 10

### Computation of Excess Profits Tax

| | |
|---|---|
| Excess profits net income adjusted | $1,772,394.07 |
| Excess profits credit | 856,274.39 |
| Adjusted excess profits net income | 916,119.68 |
| 30% of $916,119.68 | 274,835.90 |
| 18% of $1,772,394.97 | 319,030.93 |
| Excess profits tax | 274,835.90 |

Year: 1953

## Schedule 11

### Adjustments to Net Income

| | | |
|---|---|---|
| Net income as disclosed by return | | $4,693,713.00 |
| Unallowable deductions and additional income: | | |
| (a) Massachusetts excise tax | $ 4,234.93 | |
| (b) Capital items | 27,655.55 | 31,890.48 |
| Total | | $4,725,603.48 |
| Nontaxable income and additional deductions: | | |
| (c) Depreciation | 7,634.60 | |
| (d) Depreciation | 4,225.90 | |
| (e) Depreciation | 3,373.94 | 15,234.44 |
| Net income adjusted | | $4,710,369.04 |

## Schedule 11-A

### Explanation of Adjustments

| | | |
|---|---|---|
| (a) Massachusetts excise tax | | 4,234.93 |
| The deduction for Massachusetts excise tax has been reduced, as follows: | | |
| Claimed on return | 354,145.45 | |
| Allowable | 349,910.52 | |
| Adjustment | 4,234.93 | |
| (b) Capital items | | 27,655.55 |

[fol. 36] The following items charged to expense are determined to be capital expenditures:

| Date | Item | Amou |
|---|---|---|
| 9/20/53 | Film reader | 350. |
| 9/28/53 | Calculator | 551. |
| 8/27/53 | Model V-35-2 Electric oven | 1,194. |
| 8/27/53 | Temperature Controller | 239. |
| 5/12/53 | Spectrophoto Meter | 3,458. |
| 3/ 5/53 | Heating Equipment | 1,517. |
| 1/14/53 | Lighting Fixtures | 1,329. |
| 1/30/53 | Acoustic Ceiling | 1,753. |
| 2/26/53 | Ceiling File | 990. |
| 2/27/53 | Electrical Install | 1,960. |
| 7/31/53 | Blower, Duct & Fittings | 688. |
| 1/22/53 | Lighting Fixtures | 223. |
| 1953 | Engineering & Design X-ray Equipment | 7,900. |
| 1953 | Engineering & Design Steno machine | 5,500. |
| | Total | 27,655. |

Depreciation has been allowed in (e) below:

| | | |
|---|---|---|
| (c) | Depreciation<br>See Schedule 6-A(d) | $ 7,634. |
| (d) | Depreciation<br>Depreciation of $4,225.90 has been allowed on items capitalized in 1952 | 4,225. |
| (e) | Depreciation<br>Depreciation of $3,373.94 has been allowed on items capitalized in (b) above. | 3,373. |

## Schedule 12

### Computation of Tax

| | |
|---|---|
| Net income adjusted | $4,710,369. |
| Combined normal tax and surtax (52% of $4,710,369.04 less $5,500.00) | 2,443,891. |
| Alternative tax (Schedule 13) | 2,443,457. |
| Excess profits tax (Schedule 15) | 847,565. |
| Income and excess profits tax liability | 3,291,023. |
| Tax assessed, Account No. 4182299 | 3,029,340. |
| Deficiency of income and excess profits tax | 261,682. |

ol. 37]

## Schedule 13

### Alternative Tax

| | |
|---|---|
| t income adjusted | 4,710,369.04 |
| ss: Excess of net long-term capital gain over net short-term capital loss | 1,670.63 |
| dinary net income | 4,708,698.41 |
| rtial tax (52% of $4,708,698.41 less $5,500.00) | 2,443,023.17 |
| x on capital gain (26% of $1,670.63) | 434.36 |
| ternative tax | 2,443,457.53 |

## Schedule 14

### Excess Profits Net Income

| | |
|---|---|
| cess profits net income as disclosed by return | 4,692,042.37 |
| d: Net adjustment to net income (Schedule 11) | 16,656.04 |
| cess profits net income adjusted | 4,708,698.41 |

## Schedule 15

### Computation of Excess Profits Tax

| | |
|---|---|
| cess profits net income adjusted | $4,708,698.41 |
| cess profits credit | 908,427.26 |
| justed excess profits net income | 3,800,271.15 |
| % of $3,800,271.15 | 1,140,081.35 |
| % of $4,708,698.41 | 847,565.71 |

## EXHIBIT A

## POLAROID CORPORATION

### Allocation of Abnormal Income

| | Total | 1952 | 1951 | 1950 | 1949 | 1948 | 1947 | 1946 | 1945 | 1944 |
|---|---|---|---|---|---|---|---|---|---|---|
| Interest credited on excess profits tax overassessment @ 6%: | | | | | | | | | | |
| **1942** | | | | | | | | | | |
| On $12,217.68 8- 8-47 to 6-13-51 | $ 2,820.11 | | $ 329.71 | $ 733.06 | $ 733.06 | $ 733.06 | $ 291.22 | | | |
| 21,836.32 6-30-47 to 6-13-51 | 5,181.79 | | 596.16 | 1,310.18 | 1,310.18 | 1,310.18 | 655.09 | | | |
| 8,417.51 3- 9-47 to 6-13-51 | 2,150.00 | | 226.93 | 505.05 | 505.05 | 505.05 | 407.92 | | | |
| 66,515.69 3-15-46 to 6-13-51 | 20,936.95 | | 1,793.19 | 3,990.94 | 3,990.94 | 3,990.94 | 3,990.94 | $ 3,180.00 | | |
| 2,803.44 9-16-45 to 6-13-51 | 968.07 | | 75.58 | 168.21 | 168.21 | 168.21 | 168.21 | 168.21 | $ 51.44 | |
| 976.46 9-16-45 to 12-31-45 | 34.52 | | | | | | | | 34.52 | |
| 99,788.56 9-16-45 to 12-31-45 | 1,742.87 | | | | | | | | 1,742.87 | |
| 66,515.69 12-31-45 to 3-15-46 | 796.37 | | | | | | | 796.37 | | |
| 23,294.01 12-31-45 to 3- 9-47 | 1,653.54 | | | | | | 255.91 | 1,397.63 | | |
| **1943** | | | | | | | | | | |
| On $71,675.36 9-16-45 to 7- 9-52 | 29,299.51 | $2,250.40 | 4,300.52 | 4,300.52 | 4,300.52 | 4,300.52 | 4,300.52 | 4,300.52 | 1,245.99 | |
| 2,538.42 7-31-50 to 7- 9-52 | 307.95 | 79.70 | 152.31 | 75.94 | | | | | | |
| 14,249.10 7-31-50 to 6-13-51 | 742.90 | | 384.14 | 358.76 | | | | | | |
| 5,820.60 3-18-48 to 6-13-51 | 1,130.79 | | 156.91 | 349.23 | 349.23 | 275.42 | | | | |
| 79,639.28 3-15-44 to 12-31-45 | 8,571.57 | | | | | | | | 4,788.35 | 3,793.22 |
| 71,675.36 12-31-45 to 3-15-46 | 858.09 | | | | | | | 858.09 | | |
| Total interest credited ... | $77,195.03 | $2,330.10 | $8,015.45 | $11,791.89 | $11,357.19 | $11,283.38 | $10,069.81 | $10,700.82 | $7,853.17 | $3,793.22 |
| Interest charged on normal and surtax deficiency @ 6%: | | | | | | | | | | |
| **1942** | | | | | | | | | | |
| On $53,134.77 9-16-45 to 6-13-51 | $18,310.37 | | $1,432.46 | $3,188.09 | $ 3,188.09 | $ 3,188.09 | $ 3,188.09 | $ 3,188.09 | $ 937.46 | |
| **1943** | | | | | | | | | | |
| On $45,747.57 9-16-45 to 6-13-51 | 15,764.74 | | 1,233.30 | 2,744.85 | 2,744.85 | 2,744.85 | 2,744.85 | 2,744.85 | 807.19 | |
| Total interest charged | $34,075.11 | | $2,665.76 | $ 5,932.94 | $ 5,932.94 | $ 5,932.94 | $ 5,932.94 | $ 5,932.94 | $1,744.65 | |
| Net interest credited | $43,119.93 | | | | | | | | | |

[fol. 39] EXHIBIT B TO PETITION

## CLAIM

TO BE FILED WITH THE COLLECTOR WHERE ASSESSMENT WAS MADE OR TAX PAID

COLLECTOR'S STAMP
(Date received)

The Collector will indicate in the block below the kind of claim filed, and fill in, where required, the certificate on the back of this form.

☒ Refund of Taxes Illegally, Erroneously, or Excessively Collected.

☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.

☐ Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

TYPE OR PRINT

Name of taxpayer or purchaser of stamps Polaroid Corporation.

Street address 730 Main Street

City, postal zone number, and State Cambridge 39, Mass.

1. District in which return (if any) was filed Boston, Mass.

2. Period (if for tax reported on annual basis, prepare separate form for each taxable year) from Jan. 1, 1951, to Dec. 31, 1951

3. Kind of tax Income and Excess Profits Tax

4. Amount of assessment, $909,441.99; dates of payment Various 1952

5. Date stamps were purchased from the Government

[fol. 40] 6. Amount to be refunded $193,908.85 plus interest or such greater amount as may be determined

7. Amount to be abated (not applicable to income, estate, or gift taxes) $

The claimant believes that this claim should be allowed for the following reasons:

In the preparation of Schedule EP (Form 1120) taxpayer failed to give effect to Sec. 456 I.R.C. in computing its excess profits tax liability.

See schedules attached for corrected computation of tax and supporting data.

| | |
|---|---|
| Tax Paid per Return as filed | $909,441.99 |
| Tax Liability—Normal and Surtax, per Return as filed | 715,533.14 |
| Overpayment | $193,908.85 |

(Attach letter-size sheets if space is not sufficient)

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct.

Dated 9/29/53

Signed POLAROID CORP
C. P. Fuller
VP & Treas

---

POLAROID CORPORATION

Index of Schedules Attached to Form 843

SCHEDULE 1 Statement Relative to taxpayer claiming Benefits of Section 456 I.R.C.

SCHEDULE 2 Computation of Excess Profits Tax Under Section 456 I.R.C. for Years 1950 and 1951

[fol. 41]

SCHEDULE 3 Computation of Net Abnormal Income and Allocation to Prior Years for the Years 1950 and 1951

| | | |
|---|---|---|
| SCHEDULE | 4 | Analysis of Discovery, Invention and Development Expenses for Years 1950 and 1951 |
| SCHEDULE | 5 | Analysis of Average Abnormal Income of Preceding Four Years for 1950 and 1951 |
| SCHEDULE | 6 | Computation of Excess Profits Credit—Year 1951 |
| SCHEDULE | 7 | Total Assets—January 1, 1951 |
| SCHEDULE | 8 | Total Liabilities—January 1, 1951 |
| SCHEDULE | 9 | Computation of Excess Profits Credit—Year 1950 |
| SCHEDULE | 10 | Total Assets—January 1, 1950 |
| SCHEDULE | 11 | Total Liabilities—January 1, 1950 |


## POLAROID CORPORATION

### STATEMENT RELATIVE TO TAXPAYER CLAIMING BENEFITS OF SEC. 456 I.R.C.

### CALENDAR YEARS 1950 AND 1951

### SCHEDULE 1

The taxpayer has been engaged in the manufacture of photographic and stereo equipment which resulted from discovery, invention of products and processes, and patent and development work carried on by its own employees over a period of more than twelve months.

In 1948, it placed on the commercial market a new type of camera, known as the Polaroid Land camera, which featured the taking and the production of a picture within [fol. 42] sixty seconds. The process has opened new fields for the use of a camera because of the ability to produce a finished photograph so quickly.

The taxpayer has also carried on extensive work in invention and development in the field of stereo optics and has developed camera lens and viewers in order to view a picture in the "Third Dimension". This new method

of viewing pictures has created a great demand in the movie industry for pictures that can be seen through viewers containing Polaroid lenses manufactured by the taxpayer.

The demand for the "picture in a minute camera" and the Polaroid sheets for the "3-D viewers" has created a source of income heretofore never experienced by this taxpayer or any other taxpayer. The income is attributable to the prior years in which the discovery, invention, patent and development work in connection with these products was carried on by the taxpayer.

[fol. 43]

## POLAROID CORPORATION

### Computation of Excess Profits Tax Under Sec. 456, I.R.C.

### SCHEDULE 2

| | 1950 | | 1951 | |
|---|---|---|---|---|
| Net Income per Return as filed before Net Operating Loss Deduction | | $744,358.08 | | $1,421,431.65 |
| Add: Adjustments made by RAR dated Feb. 3, 1953 excluding Net Operating Loss Deduction | | 66,585.73 | | — |
| Net Income—as Adjusted | | $810,943.81 | | $1,421,431.65 |
| Less: Net Gain from Sale of Capital Assets | $ 2,109.65 | | $ 1,334.37 | |
| Net Operating Loss Deduction | — | 2,109.65 | — | 1,334.37 |
| | | $808,834.16 | | $1,420,097.28 |
| Less: Allocation of Net Abnormal Income attributable to prior years: | | | | |
| From 1950 | | 359,355.00 | | |
| From 1951 | | — | | 689,714.00 |
| | | $449,479.16 | | $ 730,383.28 |
| Add: Allocation of Net Abnormal Income attributable to Current Year: | | | | |
| From 1951 | | 107,926.00 | | — |
| Excess Profits Net Income | | $557,405.16 | | $ 730,383.28 |
| Less: Excess Profits Credit | $722,552.51 | | $792,032.48 | |
| Unused Excess Profits Tax Credit — Carried over from 1950 | — | 722,552.51 | 83,252.36 | 875,284.84 |
| Adjusted Excess Profits Net Income | | ($165,147.35) | | ($ 144,901.56) |
| Unused Excess Profits Credit Adjustment: | | | | |
| 184/365 of $165,147.35 | | $ 83,252.36 | | |
| Tax per above | | $ — | | $ — |
| Tax per Return as filed | | — | | 193,908.85 |
| Tax Refund Due Taxpayer | | $ — | | $ 193,908.85 |

[fol. 44]



## POLAROID CORPORATION

**Computation of Abnormal Income and Allocation to Prior Years**
**For Years 1950 and 1951**

### SCHEDULE 3

| | Year 1950 | | | Year 1951 | | |
|---|---|---|---|---|---|---|
| | Photo | Stereo | Total | Photo | Stereo | Total |
| 1. Amount of Abnormal Income Received in Current Year | $5,057,908 | $ 15,385 | $5,073,293 | $ 7,394,385 | 39,543 | $ 7,433,928 |
| 2. Amount of Abnormal Income for four previous years | 5,418,[illegible] | 97,935 | 5,516,113 | 10,476,086 | 88,179 | 10,564,265 |
| 3. Average of #2 | 1,354,545 | 24,484 | 1,379,029 | 2,619,022 | 22,045 | 2,641,067 |
| 4. 115% of #3 | | | 1,585,883 | | | 3,037,227 |
| 5. Deduction in Current Year (Costs and Expenses) attributable to #1 | 4,443,395 | 9,718 | 4,453,113 | 6,163,279 | 1,726 | 6,185,005 |
| 6. Ratio of Excess of Item #1 over #4 to Item #1 | | | 68.74056% | | | 9.14371% |
| 7. Deductible Costs—Item #5 times Item #6 | | | 3,061,095 | | | 3,658,041 |
| 8. Net Abnormal Income—Item #1 less #4 Less #7 | | | 426,315 | | | 738,660 |
| 9. Gross Income by Products—Item #1 | 5,057,908 | 15,385 | 5,073,293 | 7,394,385 | 39,543 | 7,433,928 |
| 10. Deductions applicable to each Product | 4,443,395 | 9,718 | 4,453,113 | 6,163,279 | 21,726 | 6,185,005 |
| 11. Excess of Item #9 over #10 | 614,513 | 5,667 | 620,180 | 1,231,106 | 17,817 | 1,248,923 |
| 12. Total of Item #11—All Products | 620,180 | 620,180 | 620,180 | 1,248,923 | 1,248,923 | 1,248,923 |
| 13. % of Item #11 to #12 | 99.08623% | 91.377% | 100.00% | 98.57341% | 1.42659% | 100.00% |
| 14. Portion of Net Abnormal Income Allocated to Each Product | $ 422,419 | $ 3,896 | $ 426,315 | $ 728,122 | $ 10,538 | $ 738,660 |
| 15. Net Abnormal Income attributable to following years based on discovery, invention, patent and development costs: | | | | | | |
| 1943 | $ —0— | $ 640 | $ 640 | $ —0— | 1,632 | $ 1,632 |
| 1944 | 1,783 | 916 | 2,699 | 2,870 | 2,334 | 5,204 |
| 1945 | 24,179 | 1,822 | 26,001 | 38,911 | 4,641 | 43,552 |
| 1946 | 96,941 | 241 | 97,182 | 156,004 | 613 | 156,617 |
| 1947 | 74,917 | 95 | 75,012 | 120,563 | 243 | 120,806 |
| 1948 | 91,120 | 0— | 91,120 | 146,638 | —0— | 146,638 |
| 1949 | 66,701 | —0— | 66,701 | 107,339 | 0 | 107,339 |
| | $ 355,641 | $ 3,714 | $ 359,355 | $ 572,325 | $ 9,463 | $ 581,788 |
| 1950 | 66,778 | 182 | 66,960 | 107,463 | 463 | 107,926 |
| | $ 422,419 | $ 3,896 | $ 426,315 | $ 679,788 | $ 9,926 | $ 689,714 |
| 1951 | [illegible] | [illegible] | [illegible] | [illegible] | [illegible] | [illegible] |

[fol. 46]

## POLAROID CORPORATION

**Analysis of Discovery, Invention and Development Expenses**

### SCHEDULE 4

| | Year 1950 | | | | Year 1951 | | | |
|---|---|---|---|---|---|---|---|---|
| | Photo | | Stereo | | Photo | | Stereo | |
| | Amount | % | Amount | % | Amount | % | Amount | % |
| 1943 | | | $ 60,695 | 16.43947 | | | $ 60,695 | 15.48437 |
| 1944 | $ 7,150 | .42217 | 86,819 | 23.51525 | $ 7,150 | .39415 | 86,819 | 22.14906 |
| 1945 | 96,943 | 5.72401 | 172,640 | 46.76018 | 96,943 | 5.34405 | 172,640 | 44.04351 |
| 1946 | 388,667 | 22.94890 | 22,806 | 6.17709 | 388,667 | 21.42553 | 22,806 | 5.81822 |
| 1947 | 300,369 | 17.73533 | 9,040 | 2.44851 | 300,369 | 16.55804 | 9,040 | 2.30626 |
| 1948 | 365,332 | 21.57109 | — | — | 365,332 | 20.13917 | — | — |
| 1949 | 267,425 | 15.79015 | — | — | 267,425 | 14.74198 | — | — |
| 1950 | 267,733 | 15.80835 | 17,203 | 4.65950 | 267,733 | 14.75896 | 17,203 | 4.38879 |
| 1951 | | | | | 120,418 | 6.63812 | 22,773 | 5.80979 |
| | $1,693,619 | 100.00000 | $ 369,203 | 100.00000 | $1,814,037 | 100.00000 | $ 391,976 | 100.00000 |

[fol. 46]

## POLAROID CORPORATION

### Analysis of Average Abnormal Income of Preceding Four Years

Schedule 5

| | Photo | Stereo |
|---|---|---|
| **For 1951** | | |
| 1947 | $ — | $ 7,077 |
| 1948 | 39,155 | 55,867 |
| 1949 | 5,379,023 | 9,850 |
| 1950 | 5,057,908 | 15,385 |
| Totals | $10,476,086 | $88,179 |
| Average | $ 2,619,022 | $22,044 |
| **For 1950** | | |
| 1946 | $ — | $25,141 |
| 1947 | — | 7,077 |
| 1948 | 39,155 | 55,867 |
| 1949 | 5,379,023 | 9,850 |
| Totals | $ 5,418,178 | $97,935 |
| Average | $ 1,354,545 | $24,484 |

[fol. 47]

## POLAROID CORPORATION

### Excess Profits Credit Based on Invested Capital
### Calendar Year 1951

Schedule 6

| | | |
|---|---|---|
| Total Assets—As Adjusted—Jan. 1, 1951 | | $3,796,417.37 |
| Total Liabilities—As Adjusted—Jan. 1, 1951 | | 493,680.21 |
| Equity Capital—January 1, 1951 | | $3,302,737.16 |
| Add Recent Loss Adjustment | | |
| 1946 Net Operating Loss — R.A.R. 6/8/50 | $1,433,379.85 | |
| 1947 Net Operating Loss — R.A.R. 6/8/50 | 2,077,940.39 | |
| 1948 Net Operating Loss — R.A.R. 2/3/53 | 822,144.82 | |
| | $4,333,465.06 | |
| 1949 Net Income—R.A.R. 2/3/53 | 808,269.70 | 3,525,195.36 |
| Total | | $6,827,932.52 |
| Equity Capital January 1, 1950 | | |
| Total Assets | $2,969,121.74 | |
| Total Liabilities | 238,763.99 | |
| Balance | $2,730,357.75 | |
| Increase in Equity Capital from January 1, 1950 to January 1, 1951 | | 572,379.41 |
| Balance | | $6,255,553.11 |

[fol. 48] *Computation of Credit*

| | | | |
|---|---|---|---|
| 12% of $5,000,000.00 | | | $ 600,000.00 |
| 10% of 1,255,553.11 | | | 125,555.31 |
| $6,255,553.11 | | | $ 725,555.31 |
| Less Inadmissable assets: | | | |
| Average daily inadmissables | | $ 14,000.00 | |
| Average daily total assets | | | |
| January 1, 1951 | $3,796,417.37 | | |
| Dec. 31, 1951 | 5,397,348.62 | 4,599,688.30 | |
| Percentage of Inadmissible to Total | | .304369% | |
| Reduction on account of Inadmissables .304369% of $725,555.31 | | | 2,208.36 |
| | | | $ 723,346.95 |
| Add 12% of $572,379.41, increase in equity capital since 1/1/50 | | | 68,685.53 |
| TOTAL EXCESS PROFITS CREDIT BASED ON INVESTED CAPITAL | | | $ 792,032.48 |

[fol. 49]

## POLAROID CORPORATION

### TOTAL ASSETS AS OF JANUARY 1, 1951

### SCHEDULE 7

| | | | |
|---|---|---|---|
| Assets beginning of Year: | | | |
| Per Tax Return | | | $3,404,257.39 |
| Adjustments by Revenue Agents Report dated 2/3/53: | | | |
| Year 1948: | | | |
| Excessive Depreciation | | $ 6,299.81 | |
| Patent Department Expense Capitalized | | 27,047.62 | |
| Repairs Capitalized | | 1,255.05 | |
| | | $34,602.48 | |
| Less: | | | |
| Amortization Allowed on Patents Capitalized | $ 795.52 | | |
| Adjustment of Gain on Sale of Equipment due to Change in Depreciation | (142.55) | 652.97 | 33,949.51 |
| Year 1949: | | | |
| Excessive Depreciation | | $59,276.24 | |
| Patent Department Expense Capitalized | | 23,665.02 | |
| Repairs Capitalized | | 11,950.53 | |
| | | $94,891.79 | |
| Less: | | | |
| Amortization Allowed on Patents Capitalized | $2,287.07 | | |
| Adjustment of abandonment Loss due to Depreciation Change | 1,998.75 | | |
| Adjustment to Gains on Sale of Equipment Due to Depreciation Change | 414.74 | 4,700.56 | 90,191.23 |

| | | | |
|---|---|---|---|
| [fol. 50] Year 1950: | | | |
| Excess Depreciation | | $46,718.43 | |
| Patent Department Expense Capitalized | | 21,267.40 | |
| Repairs Capitalized | | 6,223.62 | |
| | | $74,209.45 | |
| Less: | | | |
| Amortization Allowed on Patents Capitalized | $3,608.61 | | |
| Adjustment to Gains on Sale of Equipment due to change in Depreciation | 708.91 | 4,317.52 | 69,891.93 |
| Refund on Section 722 Claim —R.A.R. dated 5/4/51 | | | 138,320.13 |
| Reorganization Expenses not deducted for Income Tax Purposes: | | | |
| Year 1938 | | $ 8,608.29 | |
| Year 1940 | | 10,829.59 | |
| Year 1945 | | 40,369.31 | 59,807.19 |
| Assets Beginning of Year— As Adjusted | | | $3,796,417.37 |

[fol. 51]

## POLAROID CORPORATION

### Total Liabilities As of January 1, 1951

### Schedule 8

| | | | |
|---|---|---|---|
| Liabilities beginning of Year: | | | |
| Liabilities per tax return | | | $403,230.53 |
| Adjustments made by R.A.R. dated 2/3/53: | | | |
| Massachusetts Income and Excise Tax for 1950 | | | |
| Liability per Federal Return | | $59,357.73 | |
| Actual (Paid in 1951) | | 61,804.13 | |
| Additional Mass. Income and Excise Tax for 1949 (Unpaid as of 12/31/52) | | $ 2,446.40<br>4,504.52 | |
| Additional Mass. Income and Excise Tax for 1950 (Unpaid as of 12/31/52) | | 4,504.52 | |
| Federal Income Taxes for 1950: | | | |
| Liability per Tax Return | $16,931.36 | | |
| Total as determined by R.A.R. (Unpaid at 12/31/52) | 94,659.19 | 77,727.83 | 90,449.68 |
| Liabilities Beginning of Year As Adjusted | | | $493,680.21 |

[fol. 52]

## POLAROID CORPORATION

### Excess Profits Credit Based on Invested Capital
### Calendar Year 1950

Schedule 9

| | | |
|---|---|---|
| Total Assets—as Adjusted | | $2,969,121 |
| Less Total Liabilities as adjusted | | 238,763 |
| Balance | | $2,730,357 |
| Add Recent Loss Adjustment | | |
| 1946 Net Operating Loss — R.A.R. 6/8/50 | $1,433,379.85 | |
| 1947 Net Operating Loss — R.A.R. 6/8/50 | 2,077,940.39 | |
| 1948 Net Operating Loss — R.A.R. 2/3/53 | 822,144.82 | |
| | $4,333,465.06 | |
| 1949 Net Income — R.A.R. 2/3/53 | 808,269.70 | 3,525,195 |
| Total | | $6,255,553 |
| *Computation of Credit* | | |
| 12% of $5,000,000.00 | $ 600,000.00 | |
| 10% of 1,255,553.11 | 125,555.31 | |
| Total Tentative Credit | | $ 725,555 |
| Less Inadmissable Assets | | |
| Average Daily Inadmissable Assets | $ 14,000.00 | |
| Average Daily Total Assets | | |
| January 1, 1950 .... $2.969,121.74 | | |
| December 31, 1950 3,796,417.37 | | |
| | 3,382,769.56 | |
| Percentage of Inadmissable to Total | .4138621% | |
| Reduction on account of Inadmissable Assets— | | |
| Total Excess Profits Credit Based on .4138621% of $725,555.31 | | 3,00 |
| Invested Capital | | $ 722,55 |

[fol. 53]

## SCHEDULE 10

| | | | |
|---|---|---|---|
| Assets—1/1/50—Per Tax Return | | | $2,646,853.69 |
| Adjustments Per R.A.R. dated 2/3/53: | | | |
| Year 1948: | | | |
| Excessive Depreciation | | $ 6,299.81 | |
| Patent Department Expense Capitalized | | 27,047.62 | |
| Repairs Capitalized | | 1,255.05 | |
| | | $34,602.48 | |
| Less: | | | |
| Amortization Allowed on Patents Capitalized | $ 795.52 | | |
| Adjustment of Gain on Sale of Equipment due to Change in Depreciation | (142.55) | 652.97 | 33,949.51 |
| Year 1949: | | | |
| Excessive Depreciation | | $59,276.24 | |
| Patent Department Expense Capitalized | | 23,665.02 | |
| Repairs Capitalized | | 11,950.53 | |
| | | $94,891.79 | |
| Less: | | | |
| Amortization Allowed on Patents Capitalized | $2,287.07 | | |
| Adjustment of Abandonment Loss due to Depreciation Change | 1,998.75 | | |
| Adjustment to Gains on Sale of Equipment due to Depreciation Change | 414.74 | 4,700.56 | 90,191.23 |
| Refund on Section 722 Claim —R.A.R. dated 5/4/51 | | | 138,320.12 |
| Reorganization Expenses not deducted for Income Tax Purposes: | | | |
| Year 1938 | | $ 8,608.29 | |
| Year 1940 | | 10,829.59 | |
| Year 1945 | | 40,369.31 | 59,807.19 |
| ASSETS BEGINNING OF YEAR—AS ADJUSTED | | | $2,969,121.74 |

[fol. 54]

## POLAROID CORPORATION

### TOTAL LIABILITIES—JANUARY 1, 1950

SCHEDULE 11

| | |
|---|---|
| Liabilities beginning of Year 1/1/50 Per Tax Return | $233,643.43 |
| Adjustments per R.A.R. dated 2/3/53 Additional Massachusetts Income and Excise Tax for 1949 | 5,770.93 |
| | $239,414.36 |
| Less Overaccrual Mass. Excise Tax | 650.37 |
| LIABILITIES AS OF JAN. 1, 1950 AS ADJUSTED | $238,763.99 |

[fol. 55] EXHIBIT C TO PETITION

COMPUTATION OF NET INCOME OF PETITIONER SUBJECT TO EXCESS PROFITS TAX FOR YEARS 1951, 1952 AND 1953, RESPECTIVELY

| | Polaroid Land camera and photographic pack | 3-D Devices |
|---|---|---|
| **1951** | | |
| Net income | $1,231,106 | $ 17,817 |
| deduct abnormal income allocated back to prior years | 679,788 | 9,926 |
| | 551,318 | 7,891 |
| add abnormal income allocated back from subsequent years | 155,601 | 39,760 |
| Net income subject to excess profits tax | 706,919 | 47,651 |
| **1952** | | |
| Net income | 1,452,759 | 2,885 |
| deduct abnormal income allocated back to prior years | 710,907 | 1,368 |
| | 741,852 | 1,517 |
| add abnormal income allocated back from subsequent years | 148,977 | 89,914 |
| Net income subject to excess profits tax | 890,829 | 91,431 |
| **1953** | | |
| Net income | 2,480,542 | 1,587,580 |
| deduct abnormal income allocated back to prior years | 1,429,570 | 772,912 |
| Net income subject to excess profits tax | 1,050,972 | 814,668 |

[fol. 56]

BEFORE THE TAX COURT OF THE UNITED STATES

[Title omitted]

ANSWER—Filed April 9, 1957

Respondent, for answer to the petition, admits and denies as follows:

1. Admits the allegations of the first sentence; admits that the returns for the periods here involved were filed with the Collector and Director of Internal Revenue for the District of Massachusetts; denies the remaining allegations.

2. Admits the allegations of the first sentence; denies the allegations of the second sentence.

3. Admits that petitioner's claim for refund for the calendar year 1951 (a copy of which is attached to the petition and marked Exhibit B) was filed with the Director of Internal Revenue, for the District of Massachusetts on October 1, 1953, within the period provided by the Internal Revenue Code for the filing of such refund claim; admits the allegations of the second sentence; denies the remaining allegations.

4. Admits the allegations.

5. (a) to (e), inclusive. Denies the allegations.

[fol. 57] 6. (a) and (b). Admits the allegations.

(c) Denies the allegations.

(d) Admits the allegations.

(e). Admits that in the latter part of 1948, petitioner placed on the market a type of camera known as the Polaroid Land camera, which produces finished photographs in one minute; denies the remaining allegations.

(f) Admits that the camera and the photographic pack required for its use were inventions; denies the remaining allegations.

(g) to (o), inclusive. Denies the allegations.

7. Denies the allegations.

8. Denies generally each and every allegation not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the relief sought be denied.

Nelson P. Rose, Chief Counsel, Internal Revenue Service.

Of Counsel: John W. Edwards, Regional Counsel; Paul J. Henry, Attorney, Internal Revenue Service, 419 Houghton-Dutton Building, 55 Tremont Street, Boston 8, Massachusetts.

ek 3/29/57

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[fol. 58]

BEFORE THE TAX COURT OF THE UNITED STATES

[Title omitted]

STIPULATION OF FACTS—March 5, 1959

It is hereby stipulated that for the purposes of this proceeding the following statements shall be accepted as facts without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated or to object to the admission of evidence of such facts on the grounds of materiality or revelancy:

1. Attached hereto and made a part hereof as indicated are the following documents:

| Documents | Exhibit Numbers |
|---|---|
| Petitioner's Claim (Form 843) dated September 29, 1953 | 1-A |
| Petitioner's Form 1120—Calendar Year 1951 | 2-B |
| Petitioner's Form 1120 (Amended)—Calendar Year 1951 | 3-C |
| Petitioner's Form 1120—Calendar Year 1952 | 4-D |
| Petitioner's Form 1120—Calendar Year 1953 | 5-E |

2. Petitioner made no sales of Polaroid Land cameras, photographic packs or photographic accessories prior to 1948.

[fol. 59] 3. The dollar amount of petitioner's sales of Polaroid Land cameras, photographic packs, and photographic accessories during the years 1948 to 1950, inclusive, was as follows:

| Year | Sales |
|---|---|
| 1948 | $ 39,155 |
| 1949 | 5,379,023 |
| 1950 | 5,057,108 |

Attached hereto and made a part hereof as Exhibit 6-F is Analysis of Classification of Sales prepared from petitioner's General and Subsidiary Ledgers.

4. The dollar amount of petitioner's sales of Polaroid Land cameras, photographic packs, and photographic accessories during the year 1951 was $7,394,385; the amount of petitioner's expenses incurred in connection with such sales was $6,164,973; the amount of petitioner's net income from such sales was $1,229,412.

5. The dollar amount of petitioner's sales of Polaroid Land cameras, photographic packs, and photographic accessories during the year 1952 was $11,076,969; the amount of petitioner's expenses incurred in connection with such sales was $9,611,657; the amount of petitioner's net income from such sales was $1,465,312.

6. The dollar amount of petitioner's sales of Polaroid Land cameras, photographic packs, and photographic accessories during the year 1953 was $17,212,784; the amount of petitioner's expenses incurred in connection with such sales was $14,727,692; the amount of petitioner's net income from such sales was $2,485,092.

7. The amount of the expenses incurred by petitioner in the invention and development of Polaroid Land cam-[fol. 60] eras, photographic packs, and photographic accessories during the years 1944 to 1953, inclusive, was as follows:

| Year | Expenses |
|---|---|
| 1944 | $ 7,150 |
| 1945 | 96,943 |
| 1946 | 388,667 |
| 1947 | 300,369 |
| 1948 | 365,332 |
| 1949 | 267,425 |
| 1950 | 267,733 |
| 1951 | 143,986 |
| 1952 | 213,776 |
| 1953 | 243,936 |

8. No expenses were incurred by petitioner in the invention and development of Polaroid Land cameras, photographic packs or photographic accessories prior to the year 1944.

9. The dollar amount of petitioner's sales of stereo products during the years 1946 to 1950, inclusive, was as follows:

| Year | Sales |
|---|---|
| 1946 | $25,141 |
| 1947 | 7,077 |
| 1948 | 55,867 |
| 1949 | 9,850 |
| 1950 | 15,385 |

10. The dollar amount of petitioner's sales of stereo products during the year 1951 was $39,543; the amount of petitioner's expenses incurred in connection with such sales was $21,726; the amount of petitioner's net income from such sales was $17,817.

11. The dollar amount of petitioner's sales of stereo products during the year 1952 was $85,443; the amount of petitioner's expenses incurred in connection with such [fol. 61] sales was $82,558; the amount of petitioner's net income from such sales was $2,885.

12. The dollar amount of petitioner's sales of stereo products during the year 1953 was $6,310,201; the amount of petitioner's expenses incurred in connection with such

sales was $4,717,671; the amount of petitioner's net income from such sales was $1,592,530.

13. The amount of expenses incurred by petitioner in the invention and development of its stereo products during the years 1943 to 1953, inclusive, was as follows:

| Year | Expenses |
|---|---|
| 1943 | $ 60,695 |
| 1944 | 86,819 |
| 1945 | 172,640 |
| 1946 | 22,806 |
| 1947 | 9,040 |
| 1948 | — |
| 1948 | — |
| 1950 | 17,203 |
| 1951 | 22,773 |
| 1952 | 51,602 |
| 1953 | 143,953 |

14. The aggregate dollar amount of petitioner's gross income resulting from sales of all its products during the years 1947 to 1953, inclusive, was as follows:

| Year | Gross Income |
|---|---|
| 1947 | $ 1,288,933 |
| 1948 | 1,062,912 |
| 1949 | 6,278,205 |
| 1950 | 6,011,582 |
| 1951 | 8,862,893 |
| 1952 | 12,465,089 |
| 1953 | 25,191,360 |

[fol. 62] 15. The Polaroid Land process including cameras, photographic packs, and photographic accessories as well as devices and technique used in the exhibition of three dimensional motion pictures including stereo products arose out of work, including research, by petitioner over a period of more than twelve months. But nothing in this paragraph contained shall be construed as in any way limiting petitioner's position that the sole purpose of such work was discovery and that such work culminated in discovery.

16. In the year 1951 the taxpayer's claims for relief under section 722 of the Internal Revenue Code of 1939 were settled and as a result interest on the resultant overassessments for the years 1942 and 1943 of $74,864.93 was computed to June 13, 1951. As a further result of this settlement on the same claims, interest on the deficiencies in income tax for those years of $34,075.11 was computed to June 13, 1951.

For the sole purpose of facilitating the trial of this proceeding it is further stipulated:

17. That if the Court should determine (1) that petitioner's income in the taxable years 1951, 1952, and 1953 from the invention by petitioner of the Polaroid Land process including cameras, photographic packs, and photographic accessories constituted abnormal income within the intendment of section 456 of the Internal Revenue Code of 1939; (2) that petitioner's income in the taxable years 1951, 1952, and 1953 from the invention by petitioner of devices and technique used in exhibition of three dimensional motion pictures including stereo products constituted abnormal income within the intendment of section 456 of the Internal Revenue Code of 1939; and (3) that in the taxable year 1951 in determining petitioner's net abnormal income arising out of interest credited on overassess-
[fol. 63] ments of excess profits tax under section 722 of the Internal Revenue Code of 1939 in the sum of $74,864.93 the interest charged on normal or surtax deficiencies of $34,075.11 was not deductible, then

(a) the amounts of net abnormal income for the years 1950 to 1953 from each of the above sources, respectively, should the Court determine the substantive issue with respect to the income from such source in petitioner's favor are as follows:

| Year | Photo | Stereo | Interest |
|---|---|---|---|
| 1950 | $ 422,419 | $ 3,896 | $ — |
| 1951 | 727,120 | 10,538 | 74,864.93 |
| 1952 | 786,315 | 1,548 | — |
| 1953 | 1,602,498 | 1,026,934 | — |
| Total | $3,538,352 | $1,042,916 | $74,864.93 |

(b) the allocation of such amounts of net abnormal income from the respective sources, should the Court determine the substantive issue with respect to the income from such source in petitioner's favor, is as follows:

| Year | Photo | Stereo | Interest |
|---|---|---|---|
| Prior to 1950 | | | |
| 1950 | 462,262 | 30,773 | 11,791.89 |
| 1951 | 212,690 | 40,495 | 8,015.45 |
| 1952 | 231,193 | 90,374 | — |
| 1953 | 170,306 | 251,613 | — |
| Total | $3,538,352 | $1,042,916 | $74,864.93 |

18. Nothing in this stipulation shall be construed in any way as any admission or concession by the Government that petitioner had abnormal income within the intendment of section 456 from sources (1) and (2) above, or that in determining petitioner's net abnormal income arising out of the interest credited on the overassessments of excess profits tax under section 722, the interest charged on the normal and surtax deficiencies was not deductible. The [fol. 64] sole purpose of this stipulation is to facilitate the trial of this proceeding by agreeing upon the computations of the amounts of net abnormal income and their allocations to prior years, should the Court determine in favor of petitioner the substantive issue with respect to the existence of such abnormal income.

(exhibits omitted)

Isaac M. Barnett, Counsel for Petitioner, Arch M. Cantrall, Chief Counsel, Internal Revenue Service.

JEM/gp 3-5-59

IN UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

MINUTE ENTRY OF ARGUMENT—April 5, 1960

On April 5, 1960, this cause came on to be heard and was fully heard by the Court, Honorable Peter Woodbury, Chief Judge, and Honorable John P. Hartigan and Honorable Bailey Aldrich, Circuit Judges, sitting.

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[fol. 65]

IN UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

No. 5622

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POLAROID CORPORATION, Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE, Respondent.

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ON PETITION FOR REVIEW OF THE DECISION
OF THE TAX COURT OF THE UNITED STATES

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Before: Woodbury, Chief Judge, and Hartigan and Aldrich, Circuit Judges.

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Isaac M. Barnett, with whom Julius Silver and Silver, Saperstein & Barnett were on brief, for petitioner.

Norman H. Wolfe, Attorney, Department of Justice, with whom Charles K. Rice, Assistant Attorney General, and Lee A. Jackson and Harry Marselli, Attorneys, Department of Justice, were on brief, for respondent.

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OPINION OF THE COURT—May 3, 1960

Aldrich, Circuit Judge: This is a petition by Polaroid Corporation, hereinafter called taxpayer, to review a de-

cision of the Tax Court holding that certain income received during the years 1951, 1952 and 1953 did not constitute "abnormal income" within the meaning of §456(a)(2), Internal Revenue Code of 1939, 64 Stat. 1186 (1951), so as to qualify for the relief provided therein from the Korean War excess profits tax.[1] The taxpayer also con- [fol. 66] tests a ruling that, in computing its net abnormal income for 1951 under §456(a)(3) of the Int. Rev. Code of 1939, the interest with which it was credited in 1951 upon its successful claim for an excess profits tax refund for the years 1942 and 1943 must be reduced by the interest it was charged on income tax deficiencies which resulted from the reduced excess profits tax. All facts were stipulated, and the only questions are of law.

Turning to the first issue, it appears that taxpayer was incorporated in 1937. In argument before this court it described itself as "a discovery company," exclusively engaged in exploiting its own discoveries. Edwin H. Land, its President and Director of Research, is internationally known for inventions in the optical and photographic fields, perhaps the most notable of which is the Polaroid Land Camera and film, income from the manufacture and sale of which constitutes the principal matter herein involved.[2] The camera and film together (they cannot be used separately) are termed by taxpayer the Polaroid Land process. This process is unique in that it enables any user to develop his own pictures and obtain positive prints anywhere, sixty seconds after exposure. Taxpayer describes this process as a "revolutionary discovery." We shall regard that characterization as accurate. Because of numerous patents, taxpayer has no competitors. The result has been a very substantial return of income.

Taxpayer, under Land's direction, started to develop its process in 1944. Much expenditure of time and money was

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[1] Excess Profits Tax Act of 1950, 64 Stat. 1137 (1951), which, with later additions, was classified as §§430-74, Int. Rev. Code of 1939, and is referred to hereinafter as the KW Act.

[2] Also involved is income from sales of taxpayer's synthetic light polarizer for 3-D motion pictures. The parties agree the issues are the same, and that this matter need not be separately considered.

required before its satisfactory achievement in 1947. Unfortunately for taxpayer, large scale production and commercial success coincided with the Korean War years, as a consequence of which income attributable in part to activi-
[fol. 67] ties in earlier years fell within the provisions of the KW Act. The Act contains several relief provisions. Taxpayer asserts that one in particular is applicable. The Commissioner has disagreed, and the Tax Court has sustained him.

Under the provisions of §456 of the KW Act, income is regarded as "abnormal income," and as such is relieved from the full incidence of the excess profits provisions by reallocation to other tax years, if it falls into certain specified "classes," and meets certain additional requirements which were here concededly met. The principal issue here is whether the income falls within that class described in §456(a)(2)(B): "Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; . . . ."[3] Taxpayer asserts that the word "discovery" is

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[3] The relevant portions of §456(a) are as follows:

"(a) Definitions. For the purposes of this section—

(1) Abnormal income. The term 'abnormal income' means income of any class described in paragraph (2) . . . if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years . . . .

(2) Separate classes of income. Each of the following subparagraph shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

[fol. 68] broad enough to encompass its process. The government contends that in the context of the Act it relates only to discovery of coal, oil, gas and other natural resources. It bases this in part upon internal evidence, and in part upon legislative history.

Starting with subparagraph (B), standing alone, we note that the word "discovery" admits of so many meanings that some interpretation is called for.[4] The possibility of a number of meanings for one word is a species of ambiguity. We then observe that the word is not isolated, but is sandwiched between the words "exploration" and "prospecting." The government, accordingly, invokes the doctrine of *noscitur a sociis.* In case of ambiguity this is an "appropriate and reasonable," though not always determinative test. *Russell Motor Car Co.* v. *United States,* 1923, 261 U.S. 514, 519. On a proper occasion "such association justifies, if it does not imperatively require," the application of a restricted meaning. *Neal* v. *Clark,* 1877, 95 U.S. 704, 709. It is particularly appropriate where one meaning of each of the grouped words has a readily apparent common denominator. Thus the words "barrel," "lock" and "stock" have each, individually, a number of quite different meanings. But if used in the phrase, "lock, stock and barrel" there could be little difficulty in determining which particular one of the several meanings was intended. The word "discovery" is clearly identified with the mining industry. See note 4, *supra.* So also are "exploration" and [fol. 69] "prospecting." Accordingly we find a consistent,

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All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

[4] According to Webster's New International Dictionary (Second Edition, Unabridged) it includes, "1. . . . Finding out or ascertaining something previously unknown or unrecognized; . . .". One of these meanings, which we will come to later, is "5. *Mining.* The original finding of part of a vein or lode. It is a prime requisite in the valid location of a mining claim."

integrated unit, each portion of which casts light upon the other.[5]

Taxpayer makes no response to this (other than that set forth in the footnote), except a bare statement that the doctrine of *noscitur a sociis* is inapplicable. Its position is that since the dictionary permits it, "discovery" must be taken to comprehend inventions, or at least major "basic" inventions. If "discovery" is to have that breadth of meaning we could not accept any distinction based upon degrees of invention.[6] While we agree that basic inventions can be described as discoveries, so may any invention, no matter how minor, if it is of sufficient consequence to be entitled to a patent. Cf. United States Constitution, Art. 1, §8, Cl. 8; 35 U.S.C. §§100(a), 101. If the word "discovery" is to be taken as broad enough to include inventions, we see no reason for including some and excluding others. We [fol. 70] are normally reluctant to adopt a construction of

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[5] Taxpayer counters by suggesting that by restricting all three words to mining there would be redundancy. That is not so. *"Discovery"* in this connection has already been defined. See note 4, *supra*. In the Encyclopedia Britannica (11th ed. 1911), in an article on Mining, is found the following: "MINING . . . . The term is not limited to [coal and ore deposits] . . . but includes . . . operations for oil, natural gas or brine . . . . *Prospecting* . . . . The work of prospecting is usually left to adventurous men . . . . The prospector is guided in his search by a knowledge of the geological conditions [etc.] . . . . *Exploratory Work* . . . . Exploratory work is associated intimately both with prospecting and with development, but the purpose is quite distinct from either prospecting, development or working, and it is of importance that this should be clearly recognized . . . ." (We quote the 11th edition of the Encyclopedia both because of its authoritative character, and because it was current when the words "exploration, discovery and prospecting" first appeared in the taxing statutes. See infra.)

[6] It seems peculiarly inappropriate that a person in taxpayer's position should be the one to attempt a distinction between original invention and subsequent minor improvements. Taxpayer possessed over a hundred patents related to the development of its process. How is one to distinguish between that part of income attributable to the original, basic invention, and that attributable to subsequent minor ones? This matter is, in a sense, moot in this case, because the parties have stipulated the amount of the tax. However, the problems it suggests are important.

a taxing statute which would create difficult administrative problems.[7] We are entirely unwilling to do so here where the act makes no suggestion of any standard.[8]

However, there is an equally serious difficulty if "discovery" is to include all processes and patented inventions. What, then, is the purpose of subparagraph (C), "Income from the sale of patents, formulae, or processes," of §456 (a)(2)? See, *supra*, note 3. True, that subparagraph relates only to income from the *sale* of the patent or process. But subparagraph (B) relates to *all* income. If "discovery" in subparagraph (B) includes inventions, what is the role of subparagraph (C)? If there is a big hole in the fence for the big cat, need there be a small hole for the small one?

The existence of subparagraph (C) casts further light upon the intended meaning and scope of subparagraph (B). Suppose that instead of manufacturing under its patents, taxpayer had licensed its process to others. Would it be [fol. 71] contended that the royalties could be claimed as abnormal income under subparagraph (B), although admit-

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[7] As will be discussed later, certain changes were made in the KW Act over its World War II (WW II) counterpart for the express purpose of avoiding such problems.

[8] In *G. D. Searle & Co.* v. *Jarecki*, 7 Cir., 1960, 274 F.2d 129, a case seemingly on all fours with this one, except that it came up on the granting of the government's motion for summary judgment of dismissal, the taxpayer claimed as abnormal income under the KW Act income from sales of certain ethical drugs. It was agreed that prior to the time taxpayer had developed and patented the formulae such compounds had never been in existence, and that they had had enormous commercial success. The court said, "The common accepted meaning of the word 'discovery' includes 'Finding out or ascertaining something previously unknown or unrecognized; as Curie's *discovery* of radium' (Webster's New International Dictionary (Unabridged 2d ed.) p. 745)." Then, cautioning that it was not "indicating any expression of opinion on the factual issue," it remanded the case to the district court to determine whether these drugs were "actually discoveries" within that definition. In view of the facts already established with relation to these drugs, we are less than clear by what tests the district court is to resolve this question, or how, in general, the Commissioner is to distinguish those patentable inventions which are discoveries from those which are not.

tedly, should there be a sale of the process, the proceeds would fall under subparagraph (C)? Rather, it seems more reasonable to hold that Congress, having specifically provided for sales, did not intend by some more general clause to cover income of a similar nature but of less magnitude, i.e., income from a single year's use. There is an even more compelling argument. It is to be noted that §456 does not group together all sources of abnormal income, but is constructed so that the income-percentage requirements must be separately applied as to each classification or group. In determining whether, for example, abnormal income resulting from a judgment (A) is of sufficient size to qualify for relief, it is not possible to take into account abnormal income from prospecting (B). There could be no purpose to this unless each classification or group was intended to have some homogeneity within itself. This is an additional reason for applying the doctrine of *noscitur a sociis* within each group, and at the same time for differentiating one group from another. Taking the statute as a whole, we cannot accept the contention that subparagraph (B) was intended to encompass taxpayer's manufacturing income resulting from its process. On the contrary, we think it clear that "discovery" as used in that subparagraph relates to the mining industries, and to nothing else.

Ordinarily we would stop here, but since the opposite conclusion was reached in *G. D. Searle & Co.* v. *Jarecki*, 7 Cir., 1960, 274 F.2d 129, *supra* n. 8, we will deal briefly with the legislative history to which the government has devoted its brief. This history falls into two parts; the use since 1918 of the words "exploration," "discovery," and "prospecting" in conjunction, solely with relation to the mining industry, and the particular changes effected by the KW Act over its predecessor, the World War II [fol. 72] Act.[9] In Title III, "War-Profits and Excess-Profits Tax," of the Revenue Act of 1918, c. 18, 40 Stat. 1057 (1919), we find a limit placed on the excess profits tax that could be

[9] Excess Profits Tax Act of 1940, c. 757, 54 Stat. 975, which, together with later additions and amendments, was classified as §§710-84, Int. Rev. Code of 1939, and is hereinafter referred to as the WW II Act.

imposed on the proceeds from "a bona fide sale of mines, oil or gas wells, . . . where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer . . . ." Section 337, 40 Stat. 1096. An identical provision in the income tax portion of the statute, §211(b), 40 Stat. 1064, limited the surtax upon such income in the case of individual taxpayers. Congressional history discloses that these provisions were designed to encourage the search for oil and ore deposits during wartime, and to offset the unfairness of taxing in a single year income which was possibly the result of many unprofitable years of prior search. See S. Rep. No. 617, 65th Cong., 3d Sess. 6 (1918) (1939—1 Cum. Bull. (Part 2) 117, 120-21). They were repeated in the income tax and the excess profits tax titles of the Revenue Act of 1921, c. 136, §§211(b), 337, 42 Stat. 237, 277. There was no further excess profits taxation until 1940, but these words continued to appear in the income tax statutes, with one exception,[10] until excess profits tax imposition returned with World War II. By that time, in the light of this repeated and almost continuous application to the mining industry (and no other), we think that these words had become well-recognized words of art.

[fol. 73] The World War II excess profits tax act exhibits a major schematic change from the earlier acts, but again we find the words "exploration," "prospecting," and "discovery" used together in a relief provision. The here relevant portion (noticeably similar, as will be seen, to §456 of the KW Act) was §721(a)(2)(C):[11] "Income resulting from

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[10] The single exception is the Revenue Act of 1934, c. 277, 48 Stat. 680. When the provision was revived in the Revenue Act of 1936, c. 690, §105, 49 Stat. 1678, the phrase in question was changed to "prospecting or exploration or [instead of "and"] discovery work," and the section as a whole was limited to oil or gas property. In this form it was carried into the Internal Revenue Code of 1939, c. 2, §105, 53 Stat. 36 (now §632 of the Int. Rev. Code of 1954).

[11] Excess Profits Tax Act of 1940, c. 757, §201, 54 Stat. 986, as amended, Excess Profits Tax Amendments of 1941, c. 10, §5, 55 Stat. 21. Subparagraph (C) of the amended act was derived from, and is practically identical to, subsection (c) of the original §721.

exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; . . . ." Discussion on the floor of Congress indicates that the mining industry was intended as one of the primary beneficiaries of this relief. See, e.g., 86 Cong. Rec. 12474-77, 12350, 12919 (1940); 87 Cong. Rec. 1636 (1941). With the Korean War enactment, subparagraph (C) of §721(a)(2) was split in two. It is interesting to note the form of this division. The words "Exploration, discovery, prospecting" were taken as one group, and placed in subparagraph (B) of the new law, while "patents, formulae, or processes" were placed together in subparagraph (C), and at the same time the words "research, or development of tangible property" were dropped. These changes "redefined and restricted" the types of income to which this special treatment was to be afforded. H.R. Rep. No. 3142, 81st Cong., 2d Sess. 63 (1950) (1951—1 Cum. Bull. 187, 231). The House and Senate reports described the excised portion as a "potential loophole of major dimensions," and stated that it was being omitted "because there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general re-[fol. 74] lief clause of the World War II law (section 722), and because the need for a reallocation of such income seemed to be materially less than in the other classes of income described . . . ." *Id.* at 13 (1951—1 Cum. Bull. at 195); S. Rep. No. 2679, 81st Cong., 2d Sess. 14 (1950) (1951—1 Cum. Bull. 240, 249). Thus even "meritorious cases" that would have come under this now excluded phrase were deliberately sacrificed in the interest of administrative simplification.[12]

[12] In this connection it is to be noted that it was stipulated that taxpayer's income from its process was "income from the sales of tangible property arising out of research and development which extended over a period of more than 12 months." Thus taxpayer must contend that it remained within the purview of this statute after the words which were the most applicable to it were removed.

In the face of this history, it would be difficult for us to feel that there was introduced into the newly created subparagraph (B) with the word "discovery" a scope of meaning which would include manufacturer's profits from inventions, whether those inventions were revolutionary, or otherwise. Taken in conjunction with internal evidence within the statute itself, we find it impossible.

We turn next to taxpayer's contention that even if it is not entitled to classify the income in question as "discovery" income under §456(a) (2) (B), it is nonetheless entitled to relief under the last sentence of subsection (a) (2). This reads, "The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary." Note 3, *supra*. The relevant regulations are set forth below.[13] We agree with taxpayer that this sentence may be [fol. 75] taken as giving the Secretary the authority to accept classifications outside of the express provisions of subparagraphs (A) - (D). But the language is permissive, and we have found nothing in the historical background indicating that the Secretary's role in agreeing to additional classifications was to be one of obligation rather than of discretion. We therefore reject any contention that the Secretary, or Commissioner, was required to grant relief on the basis of a classification suggested by a taxpayer

[13] Treas. Regs. 130, §40.456-2(b) (1951), as amended, T.D. 6026, 1953—2 Cum. Bull. 235: "Other income, not within a class described in subparagraphs (A) - (D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A) - (D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)."

merely because the taxpayer has income which meets the other tests of abnormality. Nor do the regulations themselves assist the taxpayer. First, any classification by a taxpayer is "subject to approval by the Commissioner," and such approval was not given here. Secondly, under this regulation the classification must be "similar to those specified in subparagraphs (A) - (D) . . . ." If "discovery" relates to mining and natural resources, taxpayer's classification is not "similar." It may be similar (if in fact it is not completely described by the phrase) to "research or development," but the regulations, in accord with the legislative history already discussed, specifically state that income of this class is not subject to relief. The last sentence of the regulations, on which taxpayer places great emphasis, furnishes it no support. That sentence merely provides that income otherwise properly includible within a class is not to be excluded merely because it happens to constitute income from research and development. However, we are unable to find, either in the statute or in the [fol. 76] regulations, any class in which to place taxpayer's income other than a classification which is specifically excluded.

One matter remains. Taxpayer, prior to the instant case, pursued a claim for relief under §722 of the WW II Act for overassessments of excess profits taxes for the years 1942 and 1943. In 1951 it was successful. In connection with the settlement it was credited with interest. The government agrees that this interest was abnormal income in 1951. Section 456(a)(2)(A). However, under the WW II Act, the reduction of taxpayer's excess profits income correspondingly increased its normal-tax income, resulting in a deficiency for those years, and an interest charge thereon. The Commissioner held, and was sustained by the Tax Court, that in computing 1951 net abnormal income this interest charge should be subtracted from the abnormal income (i.e., the interest credit) as one of the "costs or deductions relating to such abnormal income, allowable in determining the normal-tax net income for the taxable year . . . ."[14]

[14] "(3) Net abnormal income. The term 'net abnormal income' means the amount of the abnormal income less, under regulations

It is true that the interest charge was a result of, and therefore attributable to, the overassessment to which the interest credit was also attributable. Therefore, in a broad sense, they were "related." It is also true that this charge would, in the general compass of the word, constitute a "deduction" "allowable in determining the normal-tax net income." Int. Rev. Code of 1939, §23(b). There is one little cloud. What is the word "costs" doing there? Hav-[fol. 77] ing in mind the broad meaning that might be given to "deductions" standing alone (as, indeed, including costs), does the presence of the word "costs" suggest that "deductions relating" was intended to mean something relating in the same manner as costs? In H.R. Rep. No. 3142, 81st Cong., 2d Sess. 63 (1951—1 Cum. Bull. 187, 231), it is stated that the clause here in question was intended principally as a "clarification of the technical provisions" of §721 (a)(3) of the WW II Act. Examination of this earlier statute[15] discloses that whatever clarity it may have lacked in other respects, it was entirely clear with regard to the present question. There the phrase corresponding to "deductions relating" ("to such abnormal income") was "expenses, . . . through the expenditure of which" ("such abnormal income was in whole or in part derived"). This was a limited, causative relationship, entirely compatible with the word "costs," and falling far short of the meaning contended for here by the government. It is true that we are to apply §456(a)(3) and not §721(a)(3). On the other hand, by reading §456(a)(3) in the manner contended by

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prescribed by the Secretary, (A) 115 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any costs or deductions relating to such abnormal income, allowable in determining the normal-tax net income for the taxable year, as the excess of the amount of such abnormal income over 115 per centum of such average amount bears to the amount of such abnormal income." Section 456(a)(3).

[15] The corresponding portion of §721(a)(3) reads as follows: ". . . direct costs or expenses, deductible in determining the normal-tax net income of the taxable year, through the expenditure of which such abnormal income was in whole or in part derived . . ."

the government we find an awkwardness in, and apparent absence of purpose for, the presence of the word "costs," while we find none if this statute is construed to read like its predecessor. In view of the legislative history, we will adopt that construction.[16]

It may be that from an "equitable" standpoint it would be appropriate for taxpayer's interest out to be offset against its interest in. But as the government was quick to assert when the shoe was on the other foot, we are [fol. 78] applying tax statutes, not principles of equity. See *Babcock & Wilcox Co.* v. *Pedrick*, 2 Cir., 1954, 212 F.2d 645, *cert. den.*, 1955, 348 U.S. 936. This ruling of the Tax Court must be set aside.

*Judgment will enter vacating the decision of the Tax Court, and remanding the case for further proceedings in accordance with this opinion.*

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IN THE UNITED STATES COURT OF APPEALS
JUDGMENT—May 3, 1960

This cause came on to be heard on the record on review from The Tax Court of the United States, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The decision of the Tax Court is vacated, and the case is remanded to that Court for further proceedings in accordance with the opinion passed down this day.

By the Court:

ROGER A. STINCHFIELD
Clerk.

Approved:

PETER WOODBURY, Ch. J.

[fol. 79] Clerk's Certificate to foregoing Transcript (omitted in printing).

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[16] For what it may be worth, we note that the example given by the Regulations (Treas. Regs. 130, §40.456-1(e) (1951)) with respect to this clause hypothesizes "deductible expenses," not just "deductions."

[fol. 80]

SUPREME COURT OF THE UNITED STATES

No. 169—October Term, 1960

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POLAROID CORPORATION, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

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ORDER ALLOWING CERTIORARI—October 10, 1960

The petition herein for a writ of certiorari to the United States Court of Appeals for the First Circuit is granted. The case is transferred to the summary calendar and set for argument immediately following No. 151.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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No. 1029 169

Office Supreme Court, U.S.
FILED
JUN 23 1960
JAMES R. BROWNING, Clerk

IN THE

# Supreme Court of the United States

**OCTOBER TERM, 1959**

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POLAROID CORPORATION,

*Petitioner,*

*against*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

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## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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*Of Counsel:*

JULIUS SILVER,
ISAAC M. BARNETT.

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# Supreme Court of the United States

**OCTOBER TERM, 1959**

POLAROID CORPORATION,
*Petitioner,*

*against*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

*To the Honorable Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:*

Petitioner prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the First Circuit, entered May 3, 1960, affirming in part a decision of the Tax Court of the United States entered November 24, 1959.

### Report of Opinions

The opinion of the United States Court of Appeals for the First Circuit, not yet officially reported, is annexed as Appendix "A" to this petition. The opinion of the Tax Court of the United States is reported at 33 TC No. 33 (1959) and is set forth in the record appendix (R. 6-18).

## Grounds of Jurisdiction

The judgment of the United States Court of Appeals for the First Circuit was dated, and entered on, May 3, 1960 (Appendix "B" to this petition). Jurisdiction of this Court is invoked under Section 1254(1) of Title 28 of the United States Code.

## Questions Presented

1. For the purpose of determining petitioner's abnormal income under Section 456 of the Internal Revenue Code of 1939, does the income resulting from its revolutionary basic scientific discoveries extending over a period of more than 12 months constitute income from "discovery" within the class of income described in Section 456(a)(2)(B)?

2. If such income is not entitled to be classified as "discovery" income under Section 456(a)(2)(B), does it nonetheless constitute abnormal income under Section 456?

## Constitutional Provisions, Statute and Regulations Involved

This case involves the following constitutional provisions, statute and regulations:

Article I, Sections 1 and 8 of the Constitution of the United States;

Section 456 of the Internal Revenue Code of 1939; and

Sections 40.456-1(a) and 40.456-2(a) and (b) of the Treasury Regulations 130 (1951) as amended, promulgated under the Internal Revenue Code.

The said constitutional provisions, statute and regulations are set forth in Appendix "C".*

## Statement of the Case

Petitioner instituted this proceeding in the Tax Court of the United States for redetermination of deficiencies determined by respondent in petitioner's income and excess profits tax amounting to $87,935.72, $220,260.07 and $261,682.44 for the years 1951, 1952 and 1953, respectively, and for a review of respondent's disallowance of petitioner's claim for refund of income and excess profits tax of $193,908.85 for the year 1951. The jurisdiction of the Tax Court was invoked under Sections 272 and 1101 of the Internal Revenue Code.

The Tax Court held that petitioner's income from certain basic scientific discoveries hereinafter described did not constitute abnormal income within the meaning of Section 456 of the Internal Revenue Code, and sustained the deficiencies as determined by respondent (R.-5).

On appeal, the Court of Appeals for the First Circuit affirmed the decision of the Tax Court on this issue.** (Appendix "A", pp. 1a-14a). This petition seeks a review of the judgment of the Court below on such issue.

Petitioner's basic scientific discoveries were (i) the Polaroid Land Process, consisting of the Polaroid Land Camera and the Polaroid Land Picture Roll—a revolutionary photographic system in which by one-step dry

* All references to statutory provisions are to the Internal Revenue Code of 1939, as amended, unless otherwise expressly specified.

** The Tax Court also held that interest credited to petitioner on a refund of excess profits tax for the years 1942 and 1943 was to be reduced by interest charged on deficiencies in income tax for those years, in determining petitioner's net abnormal income from "interest". The determination of the Tax Court on this issue was reversed by the Court of Appeals and such issue is not involved on this petition.

processing the developing and printing of the picture take place simultaneously within the camera, enabling the user to obtain a finished dry positive print directly from the camera within 60 seconds, and (ii) the Polaroid 3-dimensional synthetic light polarizer—a device used in the exhibition of 3-dimensional motion pictures.

All of the facts were stipulated, and the only question was the construction of Section 456(a)(2).*

Petitioner contended that its income from the Polaroid Land Process and the Polaroid 3-dimensional synthetic light polarizer fell within the class of income described in subparagraph (B) of Section 456(a)(2)**, as income resulting from "discovery"; that even if said income were not properly classifiable under said subparagraph (B), the Secretary was obligated to classify it by virtue of the last sentence of paragraph (2)***: that the Treasury Regulations implementing said last sentence of paragraph (2)†, should be so construed as to allow such income to con-

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* Under paragraph (1) of Section 456(a) income is abnormal if it falls within a class under paragraph (2) and in amount exceeds 115% of the average gross income of the same class during the four previous tax years. That petitioner's income from each of its scientific discoveries during the respective tax years met the mathematical requirement of paragraph (1) was conceded (Appendix "A", p. 3a).

** "(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months".

*** "The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary".

† "Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. * * *" (Regulations 130, section 40.456-2b (Appendix "C", pp. 22a-23a).)

stitute a class of income under Section 456(a)(2); and that if not so construed, the Regulations are invalid as reducing the area of relief provided in the statute.

The Court of Appeals conceded that the Polaroid Land Process and the Polaroid 3-dimensional synthetic light polarizer were revolutionary discoveries (Appendix "A", p. 2a), but held that the word "discovery" in subparagraph (B) of Section 456(a)(2) relates solely to the mining industries and does not encompass scientific discoveries, whatever their nature or magnitude (Appendix "A", p. 8a). The Court of Appeals further held that the last sentence of Section 456(a)(2), while authorizing the Secretary to accept classifications outside the express provisions of subparagraphs (A) to (D), did not obligate the Secretary to do so, and that the Treasury Regulations did not establish any class of income in which to place petitioner's income from its scientific discoveries (Appendix "A", pp. 11a-12a).

## Reasons for Granting the Writ

I. The decision below is in direct conflict with the decision of the Court of Appeals for the Seventh Circuit in *G. D. Searle & Co.* v. *Jarecki*, 274 F. (2d) 129 (1960).

II. This case presents an important question of Federal excess profits tax law which has not been, but should be, decided by this Court.

The Government has filed with this Court its petition for a writ of certiorari to review the judgment of the Court of Appeals for the Seventh Circuit in the *Searle* case, supra. In such petition the Government has stated:

> "• • • The Court of Appeals for the First Circuit in Polaroid Corp. v. Commissioner (decided May 3, 1960) • • • has expressly disagreed with the Seventh Circuit's decision here. We have been

advised that the taxpaper in *Polaroid* will seek review by this Court, and the Government intends not to oppose the petition in that case" (Government's petition for a writ of certiorari, No. 1011, filed June 16, 1960, p. 4).

## I

**The decision below directly conflicts with the decision of the Court of Appeals for the Seventh Circuit in *G. D. Searle & Co.* v. *Jarecki*, 274 F (2d) 129 (1960).**

In *G. D. Searle & Co.* v. *Jarecki*, 274 F (2d) 129 (1960),* the taxpayer asserted that its income from the drugs Banthine and Dramamine qualified as income from "discovery" within Section 456(a)(2)(B). The District Court granted summary judgment in favor of the Government, dismissing the complaint.**

The Court of Appeals for the Seventh Circuit held that the word "discovery", as used in the statute, did embrace scientific discoveries, and reversed and remanded the case to the District Court for determination of whether Banthine and Dramamine were in fact discoveries. This decision squarely conflicts with the determination of the Court below "that 'discovery', as used in subparagraph (B) of Section 456(a)(2), relates to the mining industries, and to nothing else." (Appendix "A", p. 8a).

This direct conflict was acknowledged in the opinion of the Court below. Characterizing the *Searle* case as "seemingly on all fours with this one, except that it came

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* For the convenience of this Court, the opinion of the Court of Appeals for the Seventh Circuit is set forth in Appendix "D", pp. 24a-29a.

** The decision of the District Court is not officially reported. It is unofficially reported at 59-1 USTC §9465 (No. Dist. Ill., East. Div. 1959).

up on the granting of the government's motion for summary judgment of dismissal", the Court below stated that "the opposite conclusion was reached" in that case (Appendix "A", pp. 6a, 8a).

The aggregate amount of taxes involved in the "discovery" issue in the present case is approximately $670,000. As stated in the complaint in the *Searle* case, *supra*, the aggregate amount of taxes involved on such issue in that case exceeds $3,600,000.* Accordingly, a definitive resolution of such issue by this Court is of importance to both the Government and petitioner.

## II

**This case presents an important question of Federal excess profits tax law which has not been, but should be, decided by this Court.**

Apart from the substantial amount of taxes involved, the question of statutory construction presented in this case and the *Searle* case is of major significance in the field of Federal excess profits taxation. A decision by this Court is essential on the question of whether Congress intended that certain of the relief provisions for abnormal income under the Excess Profits Tax Act of 1950 should pertain only to special industries, or whether Congress intended generally to provide relief for all corporations having such abnormal income.

The meaning ascribed by the Court below to the word "discovery" in Section 456(a)(2)(B), as confined only

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* In the Government's petition to this Court for a writ of certiorari in the *Searle* case it is stated:

> "In addition, as the result of a preliminary search, the Internal Revenue Service informs us that there are pending administratively (or in the Tax Court) at least five other cases, involving approximately six million dollars in taxes" (Government's petition for a writ of certiorari, No. 1011, filed June 16, 1960, p. 7).

to the extractive industries, penalizes and discriminates against enterprises which have encouraged their most talented and resourceful people to apply their knowledge, training and acumen to the discovery of breakthrough inventions. In this era when scientific discoveries are of vital importance to the nation's welfare, when the survival of our civil, political and economic way of life may depend upon building strength through invention, the efforts and achievements of our scientists are among our major natural resources. During the war period in which the statute was enacted, the encouragement of basic scientific discovery was as essential to the nation's interests as the encouragement of the discovery of sources of ores and oil. In that context it is difficult to conceive that Congress intended to deny to a basic scientific "discovery" the tax relief afforded to the "discovery" of oil and minerals.

Webster's New International Dictionary (Second Edition) defines "discovery" as follows:

> "discovery: Act, fact, process or instance of discovering, as: *a* Finding out or ascertaining something previously unknown or unrecognized * * *."

Consistent with this common meaning, Congress since 1790 has used the word "discovery" throughout our statutes pertaining to patentable inventions.*

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* Section 101 of 35 U. S. Code provides: "Whoever invents or discovers any new and useful process * * * may obtain a patent therefor". For further instances of the usage together of "invention and discovery" in the patent statutes, see the so-called Boykin Act, Public Law 690, 79th Cong. 2d Session, ch. 910; 60 Stat. 940, sections 2, 2(a), 2(b), 3; the so-called Veterans Patent Extensions Act, 64 Stat. 316, as amended by 66 Stat. 321; the Tennessee Valley Authority Act, 16 U. S. Code, Sec. 831d(i); the Mutual Security Assistance Act, 22 U. S. Code, Sec. 1668; the Atomic Energy Act, 42 U. S. Code, Sec. 2181, Sec. 2182; see also the Rules of Practice of the U. S. Patent Office, particularly Rules 65, 67 and 71.

In addition, our case law is replete with instances of the use of the word "discovery" by distinguished jurists to describe the contribution made by an invention.*

Cf. *Eibel Process Company* v. *Minnesota & Ontario Paper Company*, 261 U. S. 45, 63 (1923) (Chief Justice *Taft*; *Harries* v. *Air King Products Co. Inc.*, 183 F (2d) 158, 162 (2 Cir., 1950) and *Gillman* v. *Stern*, 114 F (2d) 28, 30, (2 Cir., 1940), cert. den. 311 U. S. 718 (1941) (Judge Learned Hand).

The determination of the Court below that a basic scientific contribution cannot constitute "discovery", as that term is used in Section 456(a)(2)(B) ignores the principle that words used in a statute are to be accorded their natural, ordinary and familiar meaning (Cf. *Avery* v. *Commissioner of Internal Revenue*, 292 U. S. 210, 214 (1934).

In view of the consistent use of "discovery" to describe significant originations in the field of science, if Congress in Section 456(a)(2)(B) had intended to limit the word solely to its geophysical meaning, it would have made its intention clear by express provision.

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* In patent law, courts have constantly distinguished between "genuine discoveries" which "advance the art substantially", and "slight improvements". *Eibel Process Company* v. *Minnesota & Ontario Paper Company*, 261 U. S. 45, 63 (1923). In the *Searle* case, *supra*, the admitted issuance of patents on the drugs in question was not in itself sufficient to establish discovery under Section 456(a)(2)(B), and the case was remanded to the District Court for determination of the issue of fact as to whether such drugs were "actually discoveries". The refusal of the Court below to recognize any difference between the "discovery" of a basic revolutionary invention, such as those concededly involved in this case, and that of an ordinary invention led it to the unwarranted conclusion that to interpret "discovery" in Section 456(a)(2)(B) as including scientific discovery would make the class of income described in Section 456(a)(2)(C) redundant (Appendix "A" p. 7a).

This was recognized by the Court of Appeals for the Seventh Circuit in the *Searle* case, *supra*:

> "If Congress had intended to limit the meaning of 'discovery' it would have been a simple matter for it to have expressly done so." (274 F. (2d) at p. 131).

Circumscription of the word's meaning also vitiates the rule that a statute is to be construed in the light of its purpose. Cf. *Central Bank* v. *United States*, 345 U. S. 639, 646 (1953); *United States* v. *Sullivan*, 332 U. S. 689, 693 (1948).

A main objective of the Excess Profits Tax Act of 1950 was to tax additional profits resulting from the wartime economy.

As was stated in House of Representatives Report No. 3142, 81st Congress, 2nd Session (1950). (51-1 CB at p. 187):

> "One of the main objectives in imposing an excess profits tax is to reach corporate profits which have been swollen by the increased tempo of the economy. An excess profits tax selects for additional tax those corporations whose profits are higher than they probably would have been in the absence of hostilities and a large military budget * * *."

The purpose of the relief provisions in such a law is to exempt abnormal income arising solely from a corporation's internal achievements and not from the stimulus of the war economy.

Cf. *Soabar Company*, 7 TC 89, 96 (1946).

Petitioner's profits during the tax years were not "higher than they probably would have been in the absence of hostilities and a large military budget". Its income

from the Polaroid Land Process and the Polaroid 3-dimensional synthetic light polarizer was derived from its own achievements and not from the stimulus of the war economy. Such income was the very kind of abnormal income for which Section 456 was designed to afford relief.

In holding that the word "discovery" relates to the mining industries and to nothing else, the Court below, in effect, declared that there is embedded in the statute, the structure of which manifests a purpose to provide general relief to all taxpayers having abnormal income, a section which affords tax relief only to special industries. The argument leading to such a narrow and discriminatory interpretation of the statute, was carefully considered and rejected by the Court of Appeals for the Seventh Circuit in the *Searle* case.*

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* In the *Searle* case, the Court said:

"We do not deem the maxim *noscitur a sociis* applicable. The wording of subparagraph (B) of the statute indicates that each word should be given significance independently of the others. It refers to 'exploration, discovery, or prospecting, or any combination of the foregoing'. The context in which the word appears suggests no reason to limit or qualify its commonly accepted meaning. That the statute herein involved omitted a provision of a similar World War II Excess Profits Tax Act which in defining abnormal income included that resulting from 'research, or development of tangible property' does not in our opinion serve to narrow the scope of the word 'discovery' as employed in the Internal Revenue Code provision here under consideration. The elimination of 'research' and 'development' as factors qualifying income for abnormal income classification served the Congressional objective of plugging 'a potential loophole of major dimensions'. And, absent the element of discovery, income resulting from research or development does not by reason of the latter factors qualify for treatment as abnormal income. But the plugging of the loophole which existed under a former Act because of the use of the unqualified terms 'research' and 'development' does not require that the word 'discovery' which the

Furthermore, the determination that the provisions of the last sentence of Section 456(a)(2) gave the Secretary the discretion but not the obligation to provide additional classifications of income, raises grave doubts as to the constitutionality of the statute (Appendix "A", p. 11a). So construed, this provision would constitute an improper delegation by Congress of its essential legislative functions, in violation of Article I, Sections 1 and 8 of the Constitution, for nowhere in the statute are there any standards, express or implied, for determining which additional classes of income the Secretary may elect to classify or refuse to classify.

Cf. *Panama Refining Co.* v. *Ryan*, 293 U. S. 388 (1935).

The words "any class" in this provision of the statute establish that the Secretary was under a mandate to classify all income and that only the designation of the class in which a particular type of income was to be placed was left to the Secretary's discretion. So construed, there would be no question as to its constitutionality.

Cf. *United States ex rel. Attorney General* v. *Delaware & Hudson Company*, 213 U. S. 366, 407 (1909).

*Knights Templars' and Masons' Life Indemnity Company* v. *Jarman*, 187 U. S. 197, 205 (1902).

The Court below adopted the characterization of petitioner as a "discovery company", exclusively engaged in exploiting its own discoveries (Appendix "A", p. 2a). Even if the word "discovery" in subparagraph (B) of

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Congress saw fit to re-employ in the later enactment be regarded as having taken on the limited and qualified meaning the Government would ascribe to it. Neither the context of Sec. 456 nor the legislative history demonstrates that the term 'discovery' was intended to describe only the discovery of that which is already in existence i.e. natural resources." (274 F (2d) at p. 131).

Section 456(a)(2) were limited to the discoveries of the mining industries, since petitioner's basic scientific discoveries were "discoveries" in a business of the type conducted by it, the income therefrom was properly grouped in a class similar to the class set forth in subparagraph (B), under the amplification of the classes of income provided in the regulations.*

The contrary construction placed upon the regulations by the Court below would make the regulations invalid as in contravention of the statute.

*Morill* v. *Jones*, 106 U. S. 466 (1883).

## CONCLUSION

**Petitioner prays that a writ of certiorari issue to the United States Court of Appeals for the First Circuit to review its judgment.**

Respectfully submitted,

DAVID SAPERSTEIN,
*Attorney for Petitioner.*

*Of Counsel:*
JULIUS SILVER,
ISAAC M. BARNETT.

* (Appendix "C", pp. 22a-23a).

## APPENDIX A

## UNITED STATES COURT OF APPEALS

FOR THE FIRST CIRCUIT

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No. 5622.

POLAROID CORPORATION,

*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

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ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES.

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Before WOODBURY, *Chief Judge*, and HARTIGAN and ALDRICH, *Circuit Judges*.

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*Isaac M. Barnett*, with whom *Julius Silver* and *Silver, Saperstein & Barnett* were on brief, for petitioner.

*Norman H. Wolfe*, Attorney, Department of Justice, with whom *Charles K. Rice*, Assistant Attorney General, and *Lee A. Jackson* and *Harry Marselli*, Attorneys, Department of Justice, were on brief, for respondent.

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### OPINION OF THE COURT.

May 3, 1960.

ALDRICH, *Circuit Judge*. This is a petition by Polaroid Corporation, hereinafter caller taxpayer, to review a de-

cision of the Tax Court holding that certain income received during the years 1951, 1952 and 1953 did not constitute "abnormal income" within the meaning of §456 (a)(2), Internal Revenue Code of 1939, 64 Stat. 1186 (1951), so as to qualify for the relief provided therein from the Korean War excess profits tax.[1] The taxpayer also contests a ruling that, in computing its net abnormal income for 1951 under §456(a)(3) of the Int. Rev. Code of 1939, the interest with which it was credited in 1951 upon its successful claim for an excess profits tax refund for the years 1942 and 1943 must be reduced by the interest it was charged on income tax deficiencies which resulted from the reduced excess profits tax. All facts were stipulated, and the only questions are of law.

Turning to the first issue, it appears that taxpayer was incorporated in 1937. In argument before this court it described itself as "a discovery company," exclusively engaged in exploiting its own discoveries. Edwin H. Land, its President and Director of Research, is internationally known for inventions in the optical and photographic fields, perhaps the most notable of which is the Polaroid Land Camera and film, income from the manufacture and sale of which constitutes the principal matter herein involved.[2] The camera and film together (they cannot be used separately) are termed by taxpayer the Polaroid Land process. This process is unique in that it enables any user to develop his own pictures and obtain positive prints anywhere, sixty seconds after exposure. Taxpayer describes this process as a "revolutionary discovery." We shall regard that characterization as accurate. Because

1. Excess Profits Tax Act of 1950, 64 Stat. 1137 (1951), which, with later additions, was classified as §§430-74, Int. Rev. Code of 1939, and is referred to hereinafter as the KW Act.

2. Also involved is income from sales of taxpayer's synthetic light polarizer for 3-D motion pictures. The parties agree the issues are the same, and that this matter need not be separately considered.

of numerous patents, taxpayer has no competitors. The result has been a very substantial return of income.

Taxpayer, under Land's direction, started to develop its process in 1944. Much expenditure of time and money was required before its satisfactory achievement in 1947. Unfortunately for taxpayer, large scale production and commercial success coincided with the Korean War years, as a consequence of which income attributable in part to activities in earlier years fell within the provisions of the KW Act. The Act contains several relief provisions. Taxpayer asserts that one in particular is applicable. The Commissioner has disagreed, and the Tax Court has sustained him.

Under the provisions of §456 of the KW Act, income is regarded as "abnormal income," and as such is relieved from the full incidence of the excess profits provisions by reallocation to other tax years, if it falls into certain specified "classes," and meets certain additional requirements which were here concededly met. The principal issue here is whether the income falls within that class described in §456(a)(2)(B): "Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; . . . ."[3] Taxpayer asserts that the word "discovery" is

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3. The relevant portions of §456(a) are as follows:

"(a) Definitions. For the purposes of this section—

(1) Abnormal income. The term 'abnormal income' means income of any class described in paragraph (2) . . . if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years. . . .

(2) Separate classes of income. Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

broad enough to encompass its process. The government contends that in the context of the Act it relates only to discovery of coal, oil, gas and other natural resources. It bases this in part upon internal evidence, and in part upon legislative history.

Starting with subparagraph (B), standing alone, we note that the word "discovery" admits of so many meanings that some interpretation is called for.[4] The possibility of a number of meanings for one word is a species of ambiguity. We then observe that the word is not isolated, but is sandwiched between the words "exploration" and "prospecting." The government, accordingly, invokes the doctrine of *noscitur à sociis*. In case of ambiguity this is an "appropriate and reasonable," though not always determinative test. *Russell Motor Car Co.* v. *United States*, 1923, 261 U. S. 514, 519. On a proper occasion "such association justifies, if it does not imperatively require," the application of a restricted meaning. *Neal* v. *Clark*, 1877, 95 U. S. 704, 709. It is particularly appropriate where one meaning of each of the grouped words has a readily apparent com-

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(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or process, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

4. According to Webster's New International Dictionary (Second Edition, Unabridged) it includes, "1. . . . Finding out or ascertaining something previously unknown or unrecognized; . . ." One of these meanings, which we will come to later, is "5. *Mining*. The original finding of part of a vein or lode. It is a prime requisite in the valid location of a mining claim."

mon denominator. Thus the words "barrel," "lock" and "stock" have each, individually, a number of quite different meanings. But if used in the phrase, "lock, stock and barrel" there could be little difficulty in determining which particular one of the several meanings was intended. The word "discovery" is clearly identified with the mining industry. See note 4, *supra*. So also are "exploration" and "prospecting." Accordingly we find a consistent, integrated unit, each portion of which casts light upon the other.[5]

Taxpayer makes no response to this (other than that set forth in the footnote), except a bare statement that the doctrine of *noscitur a sociis* is inapplicable. Its position is that since the dictionary permits it, "discovery" must be taken to comprehend inventions, or at least major "basic" inventions. If "discovery" is to have that breadth of meaning we could not accept any distinction based upon degrees of invention.[6] While we agree that basic inven-

5. Taxpayer counters by suggesting that by restricting all three words to mining there would be redundancy. That is not so. *"Discovery"* in this connection has already been defined. See note 4, *supra*. In the Encyclopedia Britannica (11th ed. 1911), in an article on Mining, is found the following: "MINING . . . . The term is not limited to [coal and ore deposits] . . . but includes . . . operations for oil, natural gas or brine . . . . *Prospecting* . . . . The work of prospecting is usually left to adventurous men . . . . The prospector is guided in his search by a knowledge of the geological conditions [etc.] . . . . *Exploratory Work* . . . . Exploratory work is associated intimately both with prospecting and with development, but the purpose is quite distinct from either prospecting, development or working, and it is of importance that this should be clearly recognized . . . ." (We quote the 11th edition of the Encyclopedia both because of its authoritative character, and because it was current when the words "exploration, discovery and prospecting" first appeared in the taxing statutes. See infra.)

6. It seems peculiarly inappropriate that a person in taxpayer's position should be the one to attempt a distinction between original invention and subsequent minor improvements. Taxpayer possessed over a hundred patents related to the development of its process. How is one to distinguish between that part of income attributable

tions can be described as discoveries, so may any invention, no matter how minor, if it is of sufficient consequence to be entitled to a patent. Cf. United States Constitution, Art. I, §8, Cl. 8; 35 U.S.C. §§100(a), 101. If the word "discovery" is to be taken as broad enough to include inventions, we see no reason for including some and excluding others. We are normally reluctant to adopt a construction of a taxing statute which would create difficult administrative problems.[7] We are entirely unwilling to do so here where the act makes no suggestion of any standard.[8]

However, there is an equally serious difficulty if "discovery" is to include all processes and patented inventions. What, then, is the purpose of subparagraph (C), "Income from the sale of patents, formulae, or processes," of

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to the original, basic invention, and that attributable to subsequent minor ones? This matter is, in a sense, moot in this case, because the parties have stipulated the amount of the tax. However, the problems it suggests are important.

7. As will be discussed later, certain changes were made in the KW Act over its World War II (WW II) counterpart for the express purpose of avoiding such problems.

8. In *G. D. Searle & Co.* v. *Jarecki*, 7 Cir., 1960, 274 F. 2d 129, a case seemingly on all fours with this one, except that it came up on the granting of the government's motion for summary judgment of dismissal, the taxpayer claimed as abnormal income under the KW Act income from sales of certain ethical drugs. It was agreed that prior to the time taxpayer had developed and patented the formulae such compounds had never been in existence, and that they had had enormous commercial success. The court said, "The common accepted meaning of the word 'discovery' includes 'Finding out or ascertaining something previously unknown or unrecognized; as Curie's *discovery* of radium' (Webster's New International Dictionary (Unabridged 2d ed.) p. 745)." Then, cautioning that it was not "indicating any expression of opinion on the factual issue," it remanded the case to the district court to determine whether these drugs were "actually discoveries" within that definition. In view of the facts already established with relation to these drugs, we are less than clear by what tests the district court is to resolve this question, or how, in general, the Commissioner is to distinguish those patentable inventions which are discoveries from those which are not.

456(a)(2)? See, *supra*, note 3. True, that subparagraph relates only to income from the *sale* of the patent or process. But subparagraph (B) relates to *all* income. If "discovery" in subparagraph (B) includes inventions, what is the rôle of subparagraph (C)? If there is a big hole in the fence for the big cat, need there be a small hole for the small one?

The existence of subparagraph (C) casts further light upon the intended meaning and scope of subparagraph (B). Suppose that instead of manufacturing under its patents, taxpayer had licensed its process to others. Would it be contended that the royalties could be claimed as abnormal income under subparagraph (B), although admittedly, should there be a sale of the process, the proceeds would fall under subparagraph (C)? Rather, it seems more reasonable to hold that Congress, having specifically provided for sales, did not intend by some more general clause to cover income of a similar nature but of less magnitude, i.e., income from a single year's use. There is an even more compelling argument. It is to be noted that §456 does not group together all sources of abnormal income, but is constructed so that the income-percentage requirements must be separately applied as to each classification or group. In determining whether, for example, abnormal income resulting from a judgment (A) is of sufficient size to qualify for relief, it is not possible to take into account abnormal income from prospecting (B). There could be no purpose to this unless each classification or group was intended to have some homogeneity within itself. This is an additional reason for applying the doctrine of *noscitur a sociis* within each group, and at the same time for differentiating one group from another. Taking the statute as a whole, we cannot accept the contention that subparagraph (B) was intended to encompass taxpayer's manufacturing income resulting

from its process. On the contrary, we think it clear that "discovery" as used in that subparagraph relates to the mining industries, and to nothing else.

Ordinarily we would stop here, but since the opposite conclusion was reached in *G. D. Searle & Co.* v. *Jarecki*, 7 Cir., 1960, 274 F2d 129, *supra* n. 8, we will deal briefly with the legislative history to which the government has devoted its brief. This history falls into two parts; the use since 1918 of the words "exploration," "discovery," and "prospecting" in conjunction, solely with relation to the mining industry, and the particular changes effected by the KW Act over its predecessor, the World War II Act.[9] In Title III, "War-Profits and Excess-Profits Tax," of the Revenue Act of 1918, c. 18, 40 Stat. 1057 (1919), we find a limit placed on the excess profits tax that could be imposed on the proceeds from "a bona fide sale of mines, oil or gas wells, . . . where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer. . . ." Section 337, 40 Stat. 1096. An identical provision in the income tax portion of the statute, §211(b), 40 Stat. 1064, limited the surtax upon such income in the case of individual taxpayers. Congressional history discloses that these provisions were designed to encourage the search for oil and ore deposits during wartime, and to offset the unfairness of taxing in a single year income which was possibly the result of many unprofitable years of prior search. See S. Rep. No. 617, 65th Cong., 3d Sess. 6 (1918) (1939—1 Cum. Bull. (Part 2) 117, 120-21). They were repeated in the income tax and the excess profits tax titles of the Revenue Act of 1921, c. 136, §§211(b), 337, 42 Stat.

9. Excess Profits Tax Act of 1940, c. 757, 54 Stat. 975, which, together with later additions and amendments, was classified as §§710-84, Int. Rev. Code of 1939, and is hereinafter referred to as the WW II Act.

237, 277. There was no further excess profits taxation until 1940, but these words continued to appear in the income tax statutes, with one exception,[10] until excess profits tax imposition returned with World War II. By that time, in the light of this repeated and almost continuous application to the mining industry (and no other), we think that these words had become well-recognized words of art.

The World War II excess profits tax act exhibits a major schematic change from the earlier acts, but again we find the words "exploration," "prospecting," and "discovery" used together in a relief provision. The here relevant portion (noticeably similar, as will be seen, to §456 of the KW Act) was §721(a)(2)(C)):[11] "Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; . . . ." Discussion on the floor of Congress indicates that the mining industry was intended as one of the primary beneficiaries of this relief. See, e.g., 86 Cong. Rec. 12174-77, 12350, 12919 (1940); 87 Cong. Rec. 1636 (1941). With the Korean War enactment, subparagraph (C) of §721(a)(2) was split in two. It is interesting to note the form of this division. The words "exploration, discovery, prospecting" were taken as one group, and placed in subparagraph (B) of the new

10. The single exception is the Revenue Act of 1934, c. 277, 48 Stat. 680. When the provision was revived in the Revenue Act of 1936, c. 690, §105, 49 Stat. 1678, the phrase in question was changed to "prospecting or exploration or [instead of "and] discovery work," and the section as a whole was limited to oil or gas property. In this form it was carried into the Internal Revenue Code of 1939, c. 2, §105, 53 Stat. 36 (now §632 of the Int. Rev. Code of 1954).

11. Excess Profits Tax Act of 1940, c. 757, §201, 54 Stat. 986, as amended, Excess Profits Tax Amendments of 1941, c. 10, §5, 55 Stat. 21. Subparagraph (C) of the amended act was derived from, and is practically identical to, subsection (c) of the original §721.

law, while "patents, formulae, or processes" were placed together in subparagraph (C), and at the same time the words "research, or development of tangible property" were dropped. These changes "redefined and restricted" the types of income to which this special treatment was to be afforded. H.R. Rep. No. 3142, 81st Cong., 2d Sess. 63 (1950) (1951—1 Cum. Bull. 187, 231). The House and Senate reports described the excised portion as a "potential loophole of major dimensions," and stated that it was being omitted "because there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (section 722), and because the need for a reallocation of such income seemed to be materially less than in the other classes of income described . . . ." *Id.* at 13 (1951—1 Cum. Bull. at 195); S. Rep. No. 2679, 81st Cong., 2d Sess. 14 (1950) (1951)—1 Cum. Bull. 240, 249). Thus even "meritorious cases" that would have come under this now excluded phrase were deliberately sacrificed in the interest of administrative simplification.[12]

In the face of this history, it would be difficult for us to feel that there was introduced into the newly created subparagraph (B) with the word "discovery" a scope of meaning which would include manufacturer's profits from inventions, whether those inventions were revolutionary, or otherwise. Taken in conjunction with internal evidence within the statute itself, we find it impossible.

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12. In this connection it is to be noted that it was stipulated that taxpayer's income from its process was "income from the sales of tangible property arising out of research and development which extended over a period of more than 12 months." Thus taxpayer must contend that it remained within the purview of this statute after the words which were the most applicable to it were removed.

We turn next to taxpayer's contention that even if it is not entitled to classify the income in question as "discovery" income under §456(a)(2)(B), it is nonetheless entitled to relief under the last sentence of subsection (a)(2). This reads, "The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary." Note 3, *supra*. The relevant regulations are set forth below.[13] We agree with taxpayer that this sentence may be taken as giving the Secretary the authority to accept classifications outside of the express provisions of subparagraphs (A)-(D). But the language is permissive, and we have found nothing in the historical background indicating that the Secretary's role in agreeing to additional classifications was to be one of obligation rather than of discretion. We therefore reject any contention that the Secretary, or Commissioner, was required to grant relief on the basis of a classification suggested by a taxpayer merely because the taxpayer has income which meets the other tests of abnormality. Nor do the regulations themselves assist the taxpayer. First, any classification by a taxpayer is "subject to approval by the Com-

13. Treas. Regs. 130, §40.456-2(b) (1951), as amended, T.D. 6026, 1953—2 Cum. Bull. 235: "Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)."

missioner," and such approval was not given here. Secondly, under this regulation the classification must be "similar to those specified in subparagraphs (A)-(D) . . . ." If "discovery" relates to mining and natural resources, taxpayer's classification is not "similar." It may be similar (if in fact it is not completely described by the phrase) to "research or development," but the regulations, in accord with the legislative history already discussed, specifically state that income of this class is not subject to relief. The last sentence of the regulations, on which taxpayer places great emphasis, furnishes it no support. That sentence merely provides that income otherwise properly includible within a class is not to be excluded merely because it happens to constitute income from research and development. However, we are unable to find, either in the statute or in the regulations, any class in which to place taxpayer's income other than a classification which is specifically excluded.

One matter remains. Taxpayer, prior to the instant case, pursued a claim for relief under §722 of the WW II Act for overassessments of excess profits taxes for the years 1942 and 1943. In 1951 it was successful. In connection with the settlement it was credited with interest. The government agrees that this interest was abnormal income in 1951. Section 456(a)(2)(A). However, under the WW II Act, the reduction of taxpayer's excess profits income correspondingly increased its normal-tax income, resulting in a deficiency for those years, and an interest charge thereon. The Commissioner held, and was sustained by the Tax Court, that in computing 1951 net abnormal income this interest charge should be subtracted from the abnormal income (i.e., the interest credit) as one of the "costs or deductions relating to such abnormal in-

come, allowable in determining the normal-tax net income for the taxable year . . . ."[14]

It is true that the interest charge was a result of, and therefore attributable to, the overassessment to which the interest credit was also attributable. Therefore, in a broad sense, they were "related." It is also true that this charge would, in the general compass of the word, constitute a "deduction" "allowable in determining the normal-tax net income." Int. Rev. Code of 1939, §23(b). There is one little cloud. What is the word "costs" doing there? Having in mind the broad meaning that might be given to "deductions" standing alone (as, indeed, including costs), does the presence of the word "costs" suggest that "deductions relating" was intended to mean something relating in the same manner as costs? In H.R. Rep. No. 3142, 81st Cong., 2d Sess. 63 (1951—1 Cum. Bull. 187, 231), it is stated that the clause here in question was intended principally as a "clarification of the technical provisions" of §721(a)(3) of the WW II Act. Examination of this earlier statute[15] discloses that whatever clarity it may have lacked in other respects, it was entirely clear with regard to the present question. There the phrase corresponding to "deductions relating" ("to such abnormal income") was "expenses, . . . through the expenditure of which" ("such

14. "(3) Net abnormal income. The term 'net abnormal income' means the amount of the abnormal income less, under regulations prescribed by the Secretary, (A) 115 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any costs or deductions relating to such abnormal income, allowable in determining the normal-tax net income for the taxable year, as the excess of the amount of such abnormal income over 115 per centum of such average amount bears to the amount of such abnormal income." Section 456(a)(3).

15. The corresponding portion of §721(a)(3) reads as follows: ". . . direct costs or expenses, deductible in determining the normal-tax net income of the taxable year, through the expenditure of which such abnormal income was in whole or in part derived . . ."

abnormal income was in whole or in part derived"). This was a limited, causative relationship, entirely compatible with the word "costs," and falling far short of the meaning contended for here by the government. It is true that we are to apply §456(a)(3) and not §721(a)(3). On the other hand, by reading §456(a)(3) in the manner contended by the government we find an awkwardness in, and apparent absence of purpose for, the presence of the word "costs," while we find none if this statute is construed to read like its predecessor. In view of the legislative history, we will adopt that construction.[16]

It may be that from an "equitable" standpoint it would be appropriate for taxpayer's interest out to be offset against its interest in. But as the government was quick to assert when the shoe was on the other foot, we are applying tax statutes, not principles of equity. See *Babcock & Wilcox Co.* v. *Pedrick*, 2 Cir., 1954, 212 F. 2d 645, *cert. den.*, 1955, 348 U. S. 936. This ruling of the Tax Court must be set aside.

*Judgment will enter vacating the decision of the Tax Court, and remanding the case for further proceedings in accordance with this opinion.*

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16. For what it may be worth, we note that the example given by the Regulations (Treas. Regs. 130, §40.456-1(e) (1951), with respect to this clause hypothesizes "deductible expenses," not just "deductions."

## APPENDIX B

## UNITED STATES COURT OF APPEALS

FOR THE FIRST CIRCUIT

No. 5622.

POLAROID CORPORATION,

*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

## JUDGMENT

May 3, 1960.

This cause came on to be heard on the record on review from The Tax Court of the United States and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The decision of the Tax Court is vacated, and the case is remanded to that Court for further proceedings in accordance with the opinion passed down this day.

By the Court:

ROGER A. STINCHFIELD
Clerk

## APPENDIX C

UNITED STATES CONSTITUTION

Article 1 Section 1:

All legislative powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.

Article 1 Section 8, Clause 18:

The Congress shall have Power * * *

To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.

## STATUTE

**Section 456 of the 1939 Internal Revenue Code**

§456. *Abnormalities in income in taxable period*

(a) *Definitions.* For the purposes of this section—

(1) *Abnormal income.* The term 'abnormal income' means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.* Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

(3) *Net abnormal income.* The term 'net abnormal income' means the amount of the abnormal income less, under regulations prescribed by the Secretary, (A) 115 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any costs or deductions relating to such abnormal income, allowable in determining the normal-tax net income for the taxable year, as the excess of the amount of such abnormal income over 115 per centum of such average amount bears to the amount of such abnormal income.

(b) *Amount attributable to other years.* The amount of the net abnormal income that is attributable to any previous or future taxable year or years, shall be determined under regulations prescribed by the Secretary. In the case of amounts otherwise attributable to future taxable years, if the taxpayer either transfers substantially all its properties or distributes any property in complete liquidation, then there shall be attributable to the first taxable year in which such transfer or distribution occurs (or if such year is previous to the taxable year in which the abnormal income is includible in gross income, to such latter taxable year) all amounts so attributable to future taxable years not included in the gross income for a previous taxable year.

(c) *Computation of tax for current taxable year.* The tax under this subchapter for the taxable year, in which the whole of such abnormal income would without re-

gard to this section be includible, shall not exceed the sum of:

(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

(2) The aggregate of the increase in the tax under this subchapter for the taxable year (computed under paragraph (1)) and for each previous taxable year which would have resulted if, for each previous taxable year to which any portion of such net abnormal income is attributable, an amount equal to such portion had been included in the gross income for such previous taxable year.

(d) *Computation of tax for future taxable year.* The amount of the net abnormal income attributable to any future taxable year shall, for the purposes of this subchapter, be included in the gross income for such taxable year.

(1) The tax under this subchapter for such future taxable year shall not exceed the sum of—

(A) the tax under this subchapter for such future taxable year computed without the inclusion in gross income of the portion of such net abnormal income which is attributable to such year; and

(B) the decrease in the tax under this subchapter for the previous taxable year in which the whole of such abnormal income would, without regard to this section, be includible which resulted by reason of the computation of such tax for such previous taxable year under the provisions of subsection (c); but the amount of such decrease shall be diminished by the aggregate of the increases in the tax under this subchapter for the future taxable year as computed under subparagraph (A) and for the taxable years intervening between such previous taxable year and such future taxable year

which have resulted because of the inclusion of the portions of such net abnormal income attributable to such intervening years in the gross income for such intervening years.

(2) If, in the application of subsection (c), net abnormal income from more than one taxable year is attributable to any future taxable year, paragraph (1) of this subsection shall be applied with respect to such future taxable year in the order of the taxable years from which the net abnormal income is attributable beginning with the earliest, as if the portion of the net abnormal income from each such year was the only amount so attributable to such future taxable year, and (except in the case of the portion for the earliest previous taxable year) as if the tax under this subchapter for the future taxable year was the tax determined under paragraph (1) with respect to the portion for the next earlier previous taxable year.

(3) If in the application of paragraph (1) to any future taxable year it is determined that the decrease in tax computed under paragraph (1) (B) with respect to the net abnormal income, a portion of which is included in the gross income for the future taxable year, does not exceed the aggregate of the increases in tax computed under paragraph (1) (B) with respect to such net abnormal income, then the portions of such net abnormal income attributable to taxable years subsequent to such future taxable year shall not be included in the gross income for such subsequent taxable year. For the purpose of computing the tax under this subchapter for a taxable year subsequent to the future taxable year, the portion of net abnormal income attributable to the future taxable year shall not be included in the gross income for such future taxable year to the extent that the inclusion of such portion of net abnormal income in the gross income for such future taxable year did not result in an increase in tax for such future taxable year by reason of the provisions of paragraph (1).

(e) *Application of section.* This section shall be applied only for the purpose of computing the tax under this subchapter as provided in subsections (c) and (d), and shall have no effect upon the computation of base period net income. For the purposes of subsections (c) and (d)—

(1) Net abnormal income means the aggregate of the net abnormal income of all classes for one taxable year.

(2) Under regulations prescribed by the Secretary, the tax under this subchapter for previous taxable years shall be computed as if the portions of net abnormal income for each previous taxable year for which the tax was computed under this section were included in the gross income for the other previous taxable years to which such portions were attributable.

(3) If both subsections (c) and (d) are applicable to any current taxable year, subsection (d) shall be applied without regard to subsection (c), and subsection (c) shall be applied as if the tax under this subchapter, except for subsection (c), was the tax computed under subsection (d) and as if the gross income and the other amounts necessary to determine the adjusted excess profits net income were those amounts which would result in the tax computed under subsection (d)."

**Regulations**

"Reg. 130, Sec. 40.456-1. *Abnormalities in income in taxable year.*—(a) Section 456 applies if abnormal income (as defined in section 456(a)) for any excess profits tax taxable year is attributable to other taxable years. The term 'abnormal income' means income of any class described in section 40.456-2 includible in the gross income of the taxpayer for any excess profits tax taxable year

(1) if it is abnormal for the taxpayer to derive gross income of such class, or (2) if the taxpayer normally derives gross income of such class but the amount of such income of such class is in excess of 115 percent of the average amount of the gross income of the same class determined for the four previous taxable years or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence. It is abnormal for a taxpayer to derive income of any class only if the taxpayer had no gross income of that class for the four previous taxable years. For the purpose of determining abnormal income under this paragraph the gross income of the class for the previous taxable years is not to be increased or decreased by any allocation under the provisions of section 456. Abnormal income is to be determined by considering classes of income, and not merely particular items. * * *"

"Reg. 130, Sec. 40.456-2. *Classification of income.* (a) Section 456(a) (2) (A), (B), (C), and (D) sets forth four separate classes of income. All the income which reasonably is classifiable in more than one class shall be classified under the one which the taxpayer irrevocably elects. Such election shall be made in the manner prescribed in section 40.456-3. The classification of income for any year must be consistent with the classification made under section 456 for previous years. The classification must also be consistent with any classification made in applying section 433(b) (9) to the taxpayer.

(b) Other income, not within a class described in subparagraphs (A)-(D) of section 456(a) (2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commission on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)

(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456 (a) (2) (D)."

## APPENDIX D

**Appeal from the United States District Court for the Northern District of Illinois, Eastern Division**

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

SEPTEMBER TERM, 1959—JANUARY SESSION, 1960

G. D. SEARLE & Co.,
*Plaintiff-Appellant,*

*v.*

JOHN T. JARECKI, former Collector of Internal Revenue, and Ernest J. Sauber, former Collector of Internal Revenue and former District Director of Internal Revenue,
*Defendants-Appellees.*

No. 12747.

January 27, 1960

CASTLE, Circuit Judge.

G. D. Searle & Co., plaintiff-appellant, referred to as taxpayer, instituted this action to recover excess profits taxes in the total amount of $3,638,238.82, plus interest, which amount it alleges was erroneously and illegally assessed and collected by the Government for the calendar years 1950, 1951, and 1952. The District Court dismissed the suit on motion for summary judgment filed by the Government. The taxpayer appealed contending

the granting of summary judgment was error in that it was based on an erroneous interpretation of the pertinent Internal Revenue Code provision and that a genuine issue of material fact existed.

The pleadings, a stipulation of facts, and answers to interrogatories and requests for admissions disclose that the taxpayer is engaged in the manufacture and marketing of ethical drugs. Prior to 1950, and over a period of more than twelve months, the taxpayer incurred expenditures which resulted in the preparation and manufacture of two pharmaceuticals with the trade names of Banthine and Dramamine. During the years here involved the taxpayer derived income from sales of these drugs. Both were developed from and arose out of research activities conducted by the taxpayer before 1950. These chemical drug compounds were not in existence prior to their being prepared through experiments with various chemical formulas. The taxpayer applied for and received patents on both products.

The taxpayer claimed that the income from the sales of Banthine and Dramamine constituted abnormal income within the meaning of Sec. 456(a) (2) of the Internal Revenue Code of 1939 (26 U. S. C. Excess Profits Taxes, 456).[1] Section 456 is designed to afford relief from the

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1. Insofar as pertinent Sec. 456 provides:

"§ 456. Abnormalities in income in taxable period—

"(a) Definitions.

"For the purposes of this section—

"(1) Abnormal income.

"The term 'abnormal income' means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in

impact of excess profits taxes in certain situations which give rise to abnormally high income during the taxable year.

The taxpayer asserted that the income from the drugs Banthine and Dramamine qualified as income resulting from "discovery" within the class of income described in Sec. 456(a) (2) (B) as:

> "Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months;"

And, alternatively, the taxpayer asserted that such income is subject to classification as abnormal income pursuant to the Treasury Regulations[2] promulgated under the provision of Sec. 456 that:

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existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

"(2) Separate classes of income.

"Each of the following subparagraphs shall be held to describe a separate class of income:

"(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

"(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

"(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

"(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting. All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

2. Treasury Regulations 130, Sec. 40.456-2(b), as amended by T.D. 6026 (1953-2) Cum. Bull. 235:

> "(b) Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable, may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in

"The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary".

The District Court held that the meaning of the word "discovery" as used in the statute, did not encompass the preparation of Banthine and Dramamine because they are products arising out of research and development, and that the Treasury Regulation, to which reference has been made, is not applicable.

The common accepted meaning of the word "discovery" includes "Finding out or ascertaining something previously unknown or unrecognized; as Curie's *discovery* of radium" (Webster's New International Dictionary (Unabridged 2d ed.) p. 745). We do not deem the maximum *noscitur a sociis* applicable. The wording of subparagraph (B) of the statute indicates that each word should be given significance independently of the others. It refers to "exploration, discovery, or prospecting, or any combination of the foregoing". The context in which the word appears suggests no reason to limit or qualify its commonly accepted meaning. That the statute herein involved omitted a provision of a similar World War II Excess Profits Tax Act which in defining abnormal income included that resulting from "research, or development of tangible property", does not in our opinion serve

---

subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)."

to narrow the scope of the word "discovery" as employed in the Internal Revenue Code provision here under consideration. The elimination of "research" and "development" as factors qualifying income for abnormal income classification served the Congressional objective of plugging "a potential loophole of major dimensions".[3] And, absent the element of discovery, income resulting from research or development does not by reason of the latter factors qualify for treatment as abnormal income. But the plugging of the loophole which existed under a former Act because of the use of the unqualified terms "research" and "development" does not require that the word "discovery" which the Congress saw fit to re-employ in the later enactment be regarded as having taken on the limited and qualified meaning the Government would ascribe to it. Neither the context of Sec. 456 nor the legislative history demonstrates that the term "discovery" was intended to describe only the discovery of that which is already in existence *i. e.* natural resources. If Congress had intended to limit the meaning of "discovery" it would have been a simple matter for it to have expressly done so.

It is our opinion that income resulting from discovery is not under the terms of subparagraph (B) of the statute precluded from classification as abnormal income merely because research or development may have occasioned, or have been factors which contributed to, the discovery. It is unnecessary to consider the argument advanced by the taxpayer concerning the application of the Treasury Regulation.

We conclude that the District Court erred in its interpretation of the statute and in granting summary judgment for the Government. A genuine issue of material fact existed as to whether Banthine and Dramamine were

3. H. Rep. No. 3142, 81st Cong., 2 Sess., p. 13 (1951-1 Cum. Bull. 187, 189).

actually discoveries. Nothing we have said should be regarded as indicating any expression of opinion on the factual issue.

The Judgment of the District Court is reversed and the cause remanded for further proceedings not inconsistent with this opinion.

Reversed and remanded.

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No. 169

# In the Supreme Court of the United States

OCTOBER TERM, 1960

POLAROID CORPORATION, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT*

## MEMORANDUM FOR THE RESPONDENT

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## MEMORANDUM FOR THE RESPONDENT

The issue in this case is identical with that in *G. D. Searle & Co.* v. *Jarecki*, 274 F. 2d 129 (C.A. 7), in which the Government has filed a petition for certiorari (No. 151, this Term). That issue is whether income received from the sale of certain patented products constitutes "abnormal income" within the meaning of Section 456(a)(2) of the Internal Revenue Code of 1939, so as to qualify for Korean War excess profits tax relief. The court below, expressly disagreeing with the Seventh Circuit, reached a directly opposite conclusion. (Pet. App. A, 2a–12a.)[1]

[1] The court below in this case also decided—adversely to the Government—a minor issue as to the proper treatment of certain interest (Pet. App. A, 12a–14a). The Government is not seeking review by this Court as to that issue.

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For the reasons set forth in its petition in *Seanle*, the Government does not oppose certiorari in this case.

Respectfully submitted.

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**BRIEF ON MERITS**

No. 169

IN THE

# Supreme Court of the United States

**OCTOBER TERM, 1960**

POLAROID CORPORATION,
*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

## BRIEF FOR THE PETITIONER

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IN THE

# Supreme Court of the United States

**OCTOBER TERM, 1960**

No. 169

POLAROID CORPORATION,

*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

## BRIEF FOR THE PETITIONER

### Opinions Below

The opinion of the Court of Appeals (R. 59-71) is reported at 278 F(2d) 148 (CA 1st, 1960). The opinion of the Tax Court of the United States (R. 4-16) is reported at 33 TC No. 33 (1959).

### Jurisdiction

The judgment of the Court of Appeals was entered May 3, 1960 (R. 71). The petition for a writ of certiorari was filed June 23, 1960, and was granted October 10, 1960 (R. 72). The jurisdiction of this Court rests on 28 U.S.C. 1952 ed., Section 1254(1).

## Constitutional Provisions, Statute and Regulations Involved

This case involves the following constitutional provisions, statute and regulations:

Article I, Sections 1 and 8 of the Constitution of the United States;

Section 456 of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed., Section 456); and

Sections 40.456-1(a) and 40.456-2(a) and (b) of Treasury Regulations 130 (1951), as amended, promulgated under the Internal Revenue Code.

Such constitutional provisions, statute and regulations are set forth in the Appendix.[1]

## Questions Presented

1. For the purpose of determining petitioner's abnormal income under Section 456 of the Internal Revenue Code of 1939, did petitioner's income in 1951, 1952 and 1953, respectively, resulting from its revolutionary basic scientific discoveries extending over a period of more than 12 months constitute income from "discovery" within the class of income described in Section 456(a)(2)(B)?

2. If such income was not entitled to be classified as "discovery" income under Section 456(a)(2)(B), was it entitled to classification by the Secretary pursuant to the last sentence of Section 456(a)(2)?

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1. The so-called Korean War Excess Profits Tax Law (added as Subchapter D of Chapter 1 of the Internal Revenue Code of 1939 by the Excess Profits Tax Act of 1950, c. 1199, Title I, sec. 101, 64 Stat. 1137) will be referred to in this brief as the "Korean War Act". The Second World War excess profits tax law (added as Subchapter E, of chapter 2 of the 1939 Code by the Second Revenue Act of 1940, c. 757, Title II, sec. 201, 54 Stat. 974, 975), as amended, will be referred to herein as the "Second World War Act". All references to statutory provisions are to the 1939 Code unless otherwise expressly specified.

## Statement of the Case

Petitioner instituted this proceeding in the Tax Court of the United States for redetermination of deficiencies determined by respondent in petitioner's income and excess profits taxes amounting to $87,935.72, $220,260.07 and $261,682.44 for the years 1951, 1952 and 1953, respectively, and for a review of respondent's disallowance of petitioner's claim for refund of income and excess profits taxes of $193,908.85 for the year 1951 (R. 16-51).

The Tax Court held that petitioner's income from certain basic scientific discoveries hereinafter described did not constitute abnormal income within the meaning of Section 456, and sustained the deficiencies as determined by respondent (R. 4-16).

On appeal, the Court of Appeals for the First Circuit affirmed the decision of the Tax Court on this issue[2] (R. 59-69, 71). The decision below directly conflicts with the decision in *G. D. Searle & Co.* v. *Jarecki*, 274 F(2d) 129 (CA 7th, 1960). On October 10, 1960 this Court allowed certiorari in both cases (R. 72, fol. 80).

Petitioner's basic scientific discoveries were (i) the Polaroid Land Process, consisting of the Polaroid Land Camera and the Polaroid Land Picture Roll—a revolutionary photographic system in which by one-step dry processing the developing and printing of the picture take place simultaneously within the camera, enabling the user to obtain a finished dry positive print directly from the

2. The Tax Court also held that interest credited to petitioner on a refund of excess profits tax for the years 1942 and 1943 was to be reduced by interest charged on deficiencies in income tax for those years, in determining petitioner's net abnormal income from "interest" (R. 14-16). The determination of the Tax Court on this issue was reversed by the Court of Appeals and such issue is not involved on this review.

camera within 60 seconds (R. 7, fol. 8), and (ii) the Polaroid 3-D Synthetic Polarizer—a device used in the exhibition of 3-dimensional motion pictures to create the three dimensional illusion (R. 5, fol. 7).

All of the facts were found by the Tax Court, and the only question was the construction of Section 456(a)(2).[3]

Petitioner contended that its income from the Polaroid Land Process and the Polaroid 3-D Synthetic Polarizer fell within the class of income described in subparagraph (B) of Section 456(a)(2),[4] as income resulting from "discovery"; that even if said income were not properly classifiable under this subparagraph (B), the Secretary was obligated to classify it by virtue of the last sentence of paragraph (2)[5]; that the Treasury regulations implementing the last sentence of paragraph (2)[6], should be so construed as to allow such income to constitute a class of income under Section 456(a)(2); and that if not so

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3. Under paragraph (1) of Section 456(a) income is abnormal if it falls within a class under paragraph (2) and in amount exceeds 115% of the average gross income of the same class during the four previous tax years. That petitioner's income from its scientific discoveries during the respective tax years met the mathematical requirement of paragraph (1) was conceded (R. 61, fol. 67). Appendix pp. 1a-2a.

4. "(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months". Appendix p. 2a.

5. "The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary". Appendix p. 2a.

6. "Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. * * *" (Regulations 130, section 40.456-2(b) (1951). Appendix pp. 7a-8a.

construed, the regulations are invalid as reducing the area of relief provided in the statute.

The Court of Appeals conceded that the Polaroid Land Process and the Polaroid 3-D Synthetic Polarizer were revolutionary discoveries (R. 60, fol. 66), but held that the word "discovery", in subparagraph (B) of Section 456(a)(2), relates solely to the mining industries and does not encompass scientific discoveries, whatever their nature or magnitude (R. 65, fol. 71). The Court of Appeals further held that the last sentence of Section 456(a)(2), while authorizing the Secretary to accept classifications outside the express provisions of subparagraphs (A) to (D), did not obligate the Secretary to do so, and that the Treasury regulations did not establish any class of income in which to place petitioner's income from its scientific discoveries (R. 68-69, fols. 74-76).

The facts, as found by the Tax Court, are as follows:

Petitioner was incorporated in 1937 and from that date to late in 1948 it engaged primarily in the business of manufacturing and selling a variety of optical products in the field of light polarization, such as polarizing sunglasses and visors, polarizing camera filters, polarizing day-driving visors and variable density windows (R. 5, fol. 7).

On February 21, 1947, at a meeting of the Optical Society of America, Dr. Edwin H. Land, petitioner's President and Director of Research, first publicly announced and demonstrated his invention of a camera and photographic film which produced a finished dry positive print directly from the camera within 60 seconds after the picture was snapped. The camera and photographic film are known respectively as the Polaroid Land Camera and Polaroid Land Picture Roll, and together they con-

stitute the Polaroid Land Process.[7] The Optical Society program referred to the Process as "a new kind of photography as revolutionary as the transition from wet plates to daylight-loading film" (R. 7, fols. 8-9).

New basic principles of photographic processing were evolved by Dr. Land in his conception of the Polaroid Land Process. There had never previously existed any photographic process in which a positive print was obtained simultaneously with the development of the negative by the application to the negative and positive receiving sheets of both the silver halide developer and the silver halide solvent. There had been no prior recognition of the possibility of simultaneously introducing the silver halide developer and the silver halide solvent and so controlling their intensities and speed of operation that the developer could perform its function in the presence of the solvent before the solvent could act upon the silver halide in the negative. The four separate steps in the prior art—the developing and fixing of the negative and the printing and fixing of the positive—were compressed in the Polaroid Land Process into one step, the developing and fixing of the negative and contemporaneous formation on a positive sheet of a positive print from the dissolved silver halide of the negative. In the Polaroid Land Picture Roll all materials required for the developing and printing are part of the film assembly. The camera in which the film is processed remains dry throughout (R. 7, fol. 9).

There were at least two major basic developments involved in the Polaroid Land Process. One was a means

7. The Polaroid Land Camera and Polaroid Land Picture Roll together are known to the scientific world and to the trade as the Polaroid Land Process. The Tax Court in its opinion referred to said process as the Polaroid Land equipment (R. 7, fol. 8). In this brief we shall refer to the process as the Polaroid Land Process.

by which high concentrations of developer and silver halide solvents were introduced simultaneously, after having been stored in a capsulating agent to keep them from oxidizing through contact with the air. The second was the process of catalyzing the precipitation of silver from the silver halide solvent onto the surface of the positive receiving sheet in such a way as to obtain a silver image with relatively minute quantities of silver (R. 7-8, fol. 9).

Prior to the conception of the Polaroid Land Process, no photographic process existed whereby the picture was taken, the negative developed, and a positive print obtained directly from the camera by a one step dry process. Dr. Land's new inventions in photographic equipment were novel (R. 8, fol. 10).

Petitioner's first patent in its "Picture in a Minute" field issued in 1948. By the end of 1953, 118 patents had issued and 91 additional applications were pending, and by the end of 1958, 238 patents had issued and 202 additional applications were pending. In 1954, the United States Patent Office created a separate subclass to handle, exclusively, patent applications in the Polaroid Land Process field (R. 8, fol. 10).

The Polaroid Land Process was first marketed by petitioner in November 1948. The camera is not usable with any film other than the Polaroid Land Picture Roll and the picture roll is not usable with any camera other than the Polaroid Land Camera. The photographic accessories marketed by petitioner, such as flash guns, light meters, filters and copymakers, have been specifically designed for the Polaroid Land Camera and have had no market apart from their use with that camera. There have been no products on the market directly competitive with the Polaroid Land Process since its introduction. In addition

to its use in producing a picture in a minute, the Polaroid Land Process is used to make instantaneous X-rays and in devices for the detection of the extent of exposure to radiation (R. 8, fol. 10).

The sales of the Polaroid Land Process during the years 1948 through 1953 resulted entirely from its capacity to produce a picture in a minute. If this Process had not made an instantaneous positive print there would have been no commercial demand for this particular camera or photographic pack during that period (R. 9, fol. 11).

Petitioner's income from the sales of the Polaroid Land Process and photographic accessories during 1948 through 1953 was income from sales of tangible property arising out of research and development which extended over a period of more than 12 months (R. 9, fol. 11).*

In 1952 and 1953, 3-dimensional (3-D) motion pictures were exhibited. The audience viewed the pictures through viewers incorporating the Polaroid 3-D Synthetic Polarizers which were necessary to give the 3-D illusion. Dr. Land invented the synthetic polarizer used in these viewers. Petitioner owned three patents which covered this polarizer. The exhibition of the 3-D motion pictures would not have been commercially practicable had petitioner's synthetic polarizer not been available. No non-infringing material for this purpose was on the market (R. 6, fol. 7).

Petitioner's income from the sale of the 3-D Synthetic Polarizers during the years 1946 through 1953 was income from sales of tangible property arising out of research and development which extended over a period of more than 12 months (R. 6, fol. 8).*

* Paragraph 15 of the Stipulation herein with respect to such work by petitioner over a period of more than 12 months, provides that nothing in said paragraph "shall be construed as in any way limiting petitioner's position that the sole purpose of such work was discovery and that such work culminated in discovery" (R. 56, fol. 62).

By the Stipulation herein (R. 53-58), in the event of a determination in favor of petitioner, counsel have agreed upon the amounts of net abnormal income and the allocation thereof to prior years arising from the Polaroid Land Process and the 3-D Synthetic Polarizer, as follows:

NET ABNORMAL INCOME

| Year | Photo | 3-D |
|---|---|---|
| 1950 | $ 422,419 | $ 3,896 |
| 1951 | 727,120 | 10,538 |
| 1952 | 786,315 | 1,548 |
| 1953 | 1,602,498 | 1,026,934 |
| Total | $3,538,352 | $1,042,916 |

ALLOCATION OF NET ABNORMAL INCOME

| Year | Photo | 3-D |
|---|---|---|
| Prior to 1950 | | |
| 1950 | $ 462,262 | $ 30,773 |
| 1951 | 212,690 | 40,495 |
| 1952 | 231,193 | 90,374 |
| 1953 | 170,306 | 251,613 |

(R. 57-58, fols. 62-63).

## Summary of Argument

1. Petitioner's income from the Polaroid Land Process and the 3-D Synthetic Polarizer, which the courts below conceded to be revolutionary discoveries (R. 13, fol. 15; R. 60, fol. 66), constituted income from "discovery" within the class described in subparagraph (B) of Section 456(a)(2) (Appendix, p. 2a). The word "discovery", as used in that subparagraph, embraces a genuine scientific

discovery creating a new art. Cf. *G. D. Searle & Co.* v. *Jarecki*, 274 F(2d) 129 (CA 7th, 1960). The interpretation that the word relates solely to the mining industries distorts its ordinary and familiar meaning. "Discovery" has been commonly used in judicial opinions and lay writings to describe new contributions in the field of science. The use of "exploration", as well as "discovery", as appropriate to the scientific field, and the context of such words in Section 721(a)(2)(C) of the Second World War Act, from which Section 456(a)(2)(B) is derived, negate the applicability of the doctrine of *noscitur a sociis* in construing subparagraph (B) (*G. D. Searle & Co.* v. *Jarecki, supra*). There is no basis in the legislative history for the premise that such words had become words of art applicable only to the mining industries. Contrary to respondent's contention, Section 337 of the Revenue Act of 1918, which limited the tax rate in certain sales of mines, oil or gas wells, was not the ancestor of Section 456(a)(2)(B). With respect to origin, the relief provisions of Section 456 for abnormalities in income are traceable to Sections 327(d) and 328 of the Revenue Act of 1918, which were applicable to all industries. The omission in subparagraph (B) of the words "research, or development of tangible property", which had appeared in Section 721(a)(2)(C) of the prior law, did not manifest an intent to confine the meaning of "discovery" to its extractive sense. The Congressional purpose for such deletion to plug, "a potential loophole" found to exist in the old law, was completely served by excluding income resulting from research and development that failed to achieve a genuine, significant scientific discovery (*G. D. Searle & Co.* v. *Jarecki, supra*).

2. If such income was not entitled to be classified under subparagraph (B), it was entitled to classification

pursuant to the last sentence of paragraph (2) of Section 456(a), which provided for additional classification by the Secretary of income of "any class" (Appendix p. 2a). The legislative history of this last sentence demonstrates that Congress intended thereby to extend the scope of the section to other types of income which, in the light of the facts present in the taxable year, were as abnormal as the described types. The construction by the Court below that this last sentence gave the Secretary the discretion but not the obligation to provide additional classifications of income, would make the provision invalid as an improper delegation by Congress of its essential legislative functions, in violation of Sections 1 and 8 of Article I of the Constitution.

3. Pursuant to the Treasury regulations issued in implementation of this last sentence of paragraph (2), (Appendix 7a-8a), petitioner properly grouped its income from its basic scientific discoveries in a class similar to the class described in subparagraph (B), as income resulting from what, in the light of the type of business conducted by petitioner, constituted "discovery". If such regulations are to be construed as denying to a taxpayer relief for abnormal income arising from its basic scientific discoveries merely because research or development may have been factors which contributed to the discoveries, the regulations are invalid as reducing the area of relief provided in the statute by the last sentence of paragraph (2). Cf. *G. D. Searle & Co.* v. *Jarecki, supra; Morrill* v. *Jones*, 106 U. S. 466 (1883).

4. The Korean War Act should be construed in the light of its purpose to select, for the imposition of an additional tax, profits which were higher than they probably would have been in the absence of hostilities and the

large military budget (H. R. Rep. No. 3142, 81st Cong., 2d Sess., December 2, 1950, 1951—1 Cum. Bull. 187). Petitioner's income from its basic scientific discoveries was not attributable to any stimulus of the war economy. As such, it was the very kind of abnormal income for which Section 456 was designed to afford relief. During the war period in which the statute was enacted, the encouragement of basic scientific discovery was as essential to the nation's interest as the encouragement of the discovery of sources of ores and oils. There is no indication of any Congressional intent to deny to a basic scientific "discovery" the tax relief afforded to the "discovery" of oil and minerals.

## ARGUMENT

### I

### Petitioner's income from the Polaroid Land Process and the 3-D Synthetic Polarizer constituted income from "discovery" within the class of income described in Section 456(a)(2)(B).

The findings of the Tax Court make clear that the new basic principles of photographic processing evolved by Dr. Land in his conception of the Polaroid Land Process created a new art (R. 7-8, fols. 9-10). Prior to the conception of the Process, no photographic process existed whereby the picture was taken, the negative developed, and a positive print obtained directly from the camera by a one step dry process (R. 8, fol. 10). The novelty and scope of this new art are attested by the large number of patents which have been issued in the "Picture in a Minute" field and by the creation by the United States Patent Office of a separate subclass to handle, exclusively, patent applications in such field (R. 8, fol. 10).

The findings also confirm the unique contribution made by Dr. Land to the field of optics by his conception of the 3-D Synthetic Polarizer (R. 5-6, fol. 7).

In its opinion, the Tax Court stated: "For purposes of this case we assume that petitioner's inventions may have been new, startling or even revolutionary" (R. 13, fol. 15); and the following statement appears in the opinion of the Court below: "Taxpayer describes this process as a 'revolutionary discovery'. We shall regard that characterization as accurate" (R. 60, fol. 66).

Dr. Land's conception of the principles embodied in the Polaroid Land Process constituted "discovery" in every sense of the word. The Process has profound significance not only for amateur photography but for fields concerned with the public health and welfare. For the surgeon with a patient on the operating table, the process makes possible the completion of an X-Ray print within one minute, as contrasted with the 20-to-35 minute developing time formerly required (R. 8, fol. 10; Trial Transcript, p. 71). For the worker exposed to the risk of atomic radiation, the Process provides a device for prompt detection of the amount of radiation to which he has been subjected (R. 8, fol. 10; Trial Transcript, p. 72). In the field of wired or wireless communication, the Process provides the means for converting a picture into impulses which may be transmitted over long distances and immediately reproduced on a receiving set (Trial Transcript, p. 73). To those fields and to many others, Dr. Land has brought genuine creativity and the solution of problems that might have remained unsolved for many years but for his discovery of the principles which led to their solution.

Prior to Dr. Land's conception of a sheet polarizer, substances capable of polarizing light were found only in nature (Trial Transcript, p. 83). Because of their high

cost and unwieldy form, these natural polarizers were not suited for commercial adaptation (Trial Transcript, pp. 85, 89-90). Dr. Land's discovery of the scientific principles underlying his invention of the 3-D Synthetic Polarizer made available an application of light polarization not theretofore possible (R. 5-6, fol. 7).

To deny that scientific contributions of this magnitude and novelty constitute "discovery", as that term is used in Section 456(a)(2)(B), is to distort the natural, ordinary and familiar meaning of the term.

It is a cardinal principle of statutory construction that words used in a statute are to be accorded their natural, ordinary and familiar meaning. *G. D. Searle & Co.* v. *Jarecki*, 274 F(2d) 129, 131 (CA 7th, 1960); *Avery* v. *Commissioner of Internal Revenue*, 292 U. S. 210, 214 (1934); *United States* v. *Van Nostrand*, 94 F(2d) 510, 512 (CA 1st, 1938).

Webster's New International Dictionary (Second Edition) defines "discovery" as follows:

> "Discovery: Act, fact, process, or instance of discovering; as: *a* Finding out or ascertaining something previously unknown or unrecognized * * *."

Consistent with this common usage, Article 1 Section 8 of the United States Constitution provides:

> "The Congress shall have Power * * * to promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and *Discoveries*." (Italics supplied.)

And Congress since 1790 has used the word "discovery" throughout our statutes pertaining to patentable inventions.[8]

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8. Section 101 of 35 U.S.C. 1952 ed. (c. 950, sec. 101, 66 Stat. 797) provides: "Whoever invents or discovers any new and useful process * * * may obtain a patent therefor". For further instances of the usage together of "invention" and "discovery" in the patent statutes, see the so-called Boykin Act, c. 910, 60 Stat. 940, secs. 2,

In addition, our case law is replete with instances of the use of the word "discovery" by distinguished jurists to describe the contribution made by an invention.

See *Eibel Process Company* v. *Minnesota & Ontario Paper Company*, 261 U. S. 45, 63 (1923) (Chief Justice Taft); *Dolbear* v. *American Bell Telephone Company* (the *Telephone Cases*), 126 U. S. 1, 532, 533 (1887) (Chief Justice Waite); *Harries* v. *Air King Products Co., Inc.*, 183 F(2d) 158, 162 (CA 2nd, 1950) and *Gillman* v. *Stern*, 114 F(2d) 28, 30, (CA 2nd, 1940) cert. den. 311 U. S. 718 (1941) (Judge Learned Hand).

Chief Justice Waite in the *Telephone Cases*, *supra*, stated:

> "Bell discovered that it [the reproduction of speech at a distance] could be done by gradually changing the intensity of a continuous electric current, so as to make it correspond exactly to the changes in the density of the air caused by the sound of the voice. This was his art. He then devised a way in which these changes of intensity could be made and speech actually transmitted. Thus his art was put in a condition for practical use.
>
> In doing this, both discovery and invention, in the popular sense of those terms, were involved: discovery in finding the art, and invention in devising the means of making it useful. For such discoveries and such inventions the law has given the discoverer and inventor the right to a patent—as discoverer, for the useful art, process, method of doing a thing he has found; and as inventor, for the means he has devised to make his discovery one of actual value. * * *" (126 U. S. 1, 532, 533).

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2(a), 2(b), 3 et seq.; the so-called Veterans Patent Extensions Act, c. 444, sec. 1, 64 Stat. 316, as amended by c. 540, 66 Stat. 321; the Tennessee Valley Authority Act, c. 32, sec. 5(i) 48 Stat. 61, 62, 16 U.S.C. 1952 ed. sec. 831d(i); the Mutual Security Act, c. 479, sec. 517, 65 Stat. 382; 22 U.S.C. 1952 ed. sec. 1668; the Atomic Energy Act, c. 1073, secs. 151, 152, 68 Stat. 943, 944, 42 U.S.C. 1952 ed. secs. 2181, 2182; see also the Rules of Practice of U. S. Patent Office, particularly rules 65, 67 and 71.

We respectfully urge that, as used in subparagraph (B) of Section 456(a)(2), the word "discovery" was intended to embrace the genuine discovery of a basic invention creating a new art.

The Court below refused to hold that such a discovery fell within the class described in subparagraph (B), stating that while it agreed "that basic inventions can be described as discoveries, so may any invention, no matter how minor, if it is of sufficient consequence to be entitled to a patent" (R. 63, fol. 69).

The Courts, however, in evaluating the contribution made by patented inventions have distinguished between "genuine discoveries" which have "advanced the art substantially", and "slight improvements". Thus, in *Eibel Process Company* v. *Minnesota & Ontario Paper Company*, 261 U. S. 45, 63 (1923), Chief Justice Taft stated:

> "In administering the patent law the court first looks into the art to find what the real merit of the alleged discovery or invention is, and whether it has advanced the art substantially. If it has done so, then the court is liberal in its construction of the patent, to secure to the inventor the reward he deserves. If what he has done works only a slight step forward, and that which he says is a discovery is on the border line between mere mechanical change and real invention, then his patent, if sustained, will be given a narrow scope, and infringement will be found only in approximate copies of the new device. It is this differing attitude of the courts toward genuine discoveries and slight improvements that reconciles the sometimes apparently conflicting instances of construing specifications and the finding of equivalents in alleged infringements. • • •"

See also *Morley Sewing-Machine Co.* v. *Lancaster*, 129 U. S. 263, 273 (1889), and cases cited therein; *Westing-*

*house* v. *Boyden Power Brake Company*, 170 U. S. 537, 561, 562 (1898).

We submit that the word "discovery" in Section 456(a)(2)(B) should be construed, as applied to the field of science, in the sense of Chief Justice Taft's reference to genuine discoveries which have advanced the art substantially. Such was the meaning ascribed to "discovery" in *G. D. Searle & Co.* v. *Jarecki*, 274 F(2d) 129, 131 (CA 7th, 1960). It is with such meaning that lay writers also use the word in referring to scientific discovery.

In an article appearing in the January 1959 issue of Fortune Magazine entitled "The 1960's: A Forecast of the Technology", the following passage appears:

> "The business of science is discovery, and discovery requires penetration of the unknown."

Hans Selye in his article "What Makes Basic Research Basic" gives the following apt description of basic discoveries:

> "To my mind, it is characteristic of great basic discoveries that they possess, to a high degree and simultaneously, three qualities: they are true not merely as facts but also in the way they are interpreted, they are generalizable and they are surprising in the light of what was known at the time of discovery." ("Adventures of the Mind" Alfred A. Knopf, (1959) 135, 139).

The Polaroid Land Process and the 3-D Synthetic Polarizer meet all of these standards of a great basic discovery.

The concern of the Court below that a distinction based on the significance of the discovery would create difficult administrative problems, is unfounded. In the present case, the Tax Court had no difficulty in determining that petitioner's inventions were "new, startling or even revo-

lutionary" (R. 13, fol. 15). The determination as to the significance of a discovery would present no more difficulty than many other determinations in the administration of our tax laws, such as, for example, whether the required percentage of a taxpayer's income during the 36-month period ending on the last day of its base period was attributable to a new product, under Section 443(a) of the Korean War Act[9] (Appendix p. 10a).

The conclusion of the Court below that the word "discovery" as used in subparagraph (B) "relates to the mining industries, and to nothing else" (R. 65, fol. 71) was predicated on an inapposite application of the so-called *noscitur a sociis* doctrine and a misconception of the legislative history of Section 456.

The *noscitur a sociis* principle has no application where there is no ambiguity in the words used.[10] *Russell Motor Car Company* v. *United States*, 261 U. S. 514, 519 (1923).

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9. Regulations 130, section 40.443-2(a) (1951) provides:

> "(a) *Substantial change in products or services.*—(1) For the purpose of section 443, there is a change in products or services only if the new products or services are substantially different from the products or services previously furnished. Ordinarily, it is necessary that the trade custom or practice [is] to treat the new products or services as being of a different class from the products or services previously furnished by the taxpayer. A mere improvement or change in style of product or service does not constitute a change in the product or service. The change must represent more than a usual or customary event in the type of business in which the taxpayer is engaged. In certain types of business it is customary to eliminate unprofitable lines and add new lines as, for example, in a business the products of which are affected by style changes. Such variation in products would not qualify as a change in products furnished. The addition of a new product to a line of varied products, as where a novelty store selling hundreds of items adds several new lines, will not ordinarily be held to constitute the addition of new products for the purpose of section 443. * * *"

10. The presence in Section 456(a)(2)(B) of the phrase "or any combination of the foregoing" shows that each of the words "exploration", "discovery", and "prospecting" was intended to have separate meaning. These words did not compose a unitary phrase,

Of such three words, only the word "prospecting" ordinarily has a restricted geophysical meaning.

Webster's New International Dictionary (Second Edition) defines "explore" as follows:

"To seek for or after; to strive to attain by search".

The same dictionary gives as synonyms of "exploration" the words "search, investigation, probe".

That "exploration" is not confined to exploring for ores or oil is apparent from the common usage of such word in other contexts. Reference is frequently made, for example, to exploration leading to the discovery of new lands, to the exploration of outer space, to the exploration of the atom, and even to exploratory surgical operations.[11]

The common meaning of both "exploration" and "discovery", as applicable to the field of science, is illustrated in the following excerpts from the article by Leonard Engel "A Guide to Understanding What Science is All

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as does "lock, stock and barrel", referred to in the opinion of the Court below (R. 62, fol. 68), which in and of itself has acquired a meaning distinct from that of its component words (Webster's New International Dictionary (Second Edition)).

By restricting these words to mining there would be redundancy. While the words may have shades of different meaning in certain contexts, when applied to mining, as the Court below has stated (R. 63, n. 5), their connotations overlap. In Section 303(a) of the Defense Production Act of 1950 (c. 932, sec. 303, 64 Stat. 801; 50 U.S.C. App., 1952 ed., sec. 2093(a)), which gave the President the power to make provision for the encouragement of "exploration, development, and mining of critical and strategic minerals and metals," the word "exploration" was apparently used as embracing prospecting and discovery. The word "exploration" was similarly used in Sections 433(a)(1)(P) and 450(b)(2) of the Korean War Act. Appendix pp. 9a, 11a.

11. In *Keystone Brass Works* v. *Commissioner of Internal Revenue*, 12 T.C. 618, 626 (1949), a case involving abnormal income under Section 721(a)(2)(C), the Court applied the word "exploration" to an activity of the taxpayer in devising techniques to meet specifications for the manufacture of a product theretofore wholly unknown to it.

About" (New York Times Book Review Section of June 14, 1959, p. 7):

> "• • • science is also a great adventure, whether the object is the *exploration* of space or the *exploration* of the atom, *the digging up of the past* or the pursuit of disease germs • • •."
>
> "An overwhelming majority of recent science books for the general public are 'fact' books relating the *discoveries* of science and how these *discoveries* have been or can be applied to man's needs. • • • Science is not simply an accumulation of research findings; it is also a procedure for pursuing and making new *discoveries*." (Italics supplied.)

Furthermore, the combined single classification in Section 721(a)(2)(C), from which Section 456(a)(2)(B) is derived, of "exploration, discovery, prospecting, research, or development of tangible property, patents, formulae or processes", demonstrates that Congress did not regard the word "exploration" or the word "discovery" or the word "prospecting" as alien to the other income producing factors specified in the same class. The inclusion of the words "exploration", "discovery", "prospecting" with "research, or development of tangible property, patents, formulae, or processes", in describing one and the same class of income, established the intention, as was appropriate in a general tax relief statute, to ascribe a broad connotation to the words "exploration, discovery, or prospecting", applicable to all types of industrial enterprise.[12] These words had the same broad meaning when repeated in Section 456(a)(2)(B).

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12. It would appear that such intention was so understood by the Secretary who, in his Regulations covering Section 721, stated:

> "An item of income resulting from exploration, discovery, prospecting, research or development is all such income for the taxable year arising out of a unit of property, such as an oil lease or other mineral property defined in section

As was stated in *G. D. Searle & Co.* v. *Jarecki*, 274 F(2d) 429, 131 (CA 7th 1960), with respect to the meaning of the word "discovery" in Section 456(a)(2)(B):

> "• • • We do not deem the maxim *noscitur a sociis* applicable. The wording of subparagraph (B) of the statute indicates that each word should be given significance independently of the others. It refers to 'exploration, discovery, or prospecting or any combination of the foregoing.' The context in which the word appears suggests no reason to limit or qualify its commonly accepted meaning. • • •
>
> • • • Neither the context of Sec. 456 nor the legislative history demonstrates that the term 'discovery' was intended to describe only the discovery of that which is already in existence *i.e.* natural resources. If Congress had intended to limit the meaning of 'discovery' it would have been a simple matter for it to have expressly done so."

The assertion of the Court below that the legislative history supports a conclusion that prior to the enactment of the Second World War Act the words "exploration", "discovery" and "prospecting" had become words of art applicable only to the mining industries, is predicated solely on Section 337 in Title III "War Profits and Excess Profits Tax" of the Revenue Act of 1918, c. 18 (40 Stat. 1057, 1096), the identical provision in Section 211(b) in the income tax portion of such statute (40 Stat. 1064), and the re-enactment of such sections in later statutes.[13] Such section provided:

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29.23(m)-1(i) of Regulations 111, a patent or a formula • • •" (Regulations 112, sec. 35.721-7 (1944)).

It is noteworthy that in such regulation the income was not stated as resulting from exploration, discovery or prospecting in the case of a unit of property such as an oil lease or other mineral property, and as resulting from research or development in the case of a patent or formula.

13. The sections were repeated in the income tax and excess profits tax titles of the Revenue Act of 1921, c. 136, secs. 211(b),

> "That in the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this title attributable to such sale shall not exceed 20 percentum of the selling price of such property or interest."

That the provisions of such section applied only to mines, oil or gas wells is, of course, obvious since the section starts with the words "In the case of a bona fide sale of mines, oil or gas wells". Moreover, the section used the words "exploration and discovery work" and not "exploration" or "discovery". In the clearly expressed context the words used in the section could have no other sense than their meaning as applied to mining.[14]

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337, 42 Stat. 227, 237, 277. The section as applicable to the income tax was carried into the Internal Revenue Code of 1939, c. 2, sec. 105, 53 Stat. 36 (now sec. 632 of the Internal Revenue Code of 1954).

14. The order in which the words appear in Section 456(a)(2)(B), ("exploration, discovery, or prospecting"), also challenges characterization of them as words of art. As applied in their extractive meaning, the natural sequence would have been to place both "prospecting" and "exploration" before "discovery", as was done in Section 337 of the Revenue Act of 1918 quoted in the text. In Rev. Rul. 236, 1953-2 Cum. Bull. 236, it is stated:

> "Exploration or prospecting by a taxpayer begins with the first field work designed to determine whether to acquire or retain the acreage in the area in which a discovery is later made. * * * Exploration is ended and discovery occurs for a pool when a well is completed that proves the presence of oil or gas in commercial quantities * * *."

When Congress has enacted legislation applicable solely to the natural resources industries, it has not left the identification of its intended beneficiaries to inference; in such instances the wording of the statutory provision has made clear, as in Section 337 of the Revenue Act of 1918, that it applied only to the designated industries.

The Court below seemingly accepted as valid respondent's unsupported contention that the derivation of the provisions of subparagraph (B) of Section 456(a)(2) may be traced back to the above-quoted Section 337 (and its income tax counterpart Section 211(b)), of the Revenue Act of 1918 (R. 65-66, fols. 71-72).[15]

This contention involves a misconception of the legislative history. Sections 327(d) and 328 of the Excess Profits Tax Title of the Revenue Act of 1918, which dealt with "abnormal conditions affecting the * * * income of the corporation",[16] and not Section 337, were the pro-

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*Continued*

Compare Sections 433(a)(1)(I), 433(a)(1)(P), 450(a) and (b) and 453(a) and (b) of the Korean War Act (Appendix pp. 8a-9a; 10a-12a; 12a-18a).

15. Respondent's brief in the Court below stated (p. 18):

"Thus, Section 105 of the 1939 Code * * * is virtually identical, even in terminology, with Section 211(b) of the Revenue Act of 1918. Section 456(b)(2)(B) [sic.] of the 1939 Code is the companion excess-profits tax provision, modified in accordance with the altered statutory framework and expanded to cover the gradual sale of the wasting asset."

Were respondent's contention correct that Congress changed the earlier provision so as to give effect to the "gradual sale of the wasting asset", a similar change would have been made in the comparable income tax section, Section 105 of the 1939 Code.

16. Section 327(d) of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1093, provided that if the excess profits tax "owing to abnormal conditions affecting the capital or income of the corporation" worked upon such corporation "an exceptional hardship" evidenced by gross disproportion between the tax computed without benefit of such section and the tax computed by reference to the representative corporations as specified in Section 328, the tax should be determined as provided in Section 328. That section provided that the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption) for the taxable year as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption) for such year. (See Appendix, pp. 24a-26a.) These sections were repeated in the Revenue Act of 1921, c. 136, secs. 327, 328, 42 Stat. 227, 275, 276.

genitors of the relief provisions of the Second World War Act and the Korean War Act for abnormal income. These were general sections, applicable to qualifying corporations in all industries. The placing of income into separate classes for the purpose of determining abnormality, and the description of the class from which the class described in subparagraph (B) of Section 456(a)(2) is derived, were first made in Section 721 of the Second World War Act. There is no basis in the legislative history to support respondent's bare contention that the class of income described in subparagraph (B) of Section 456(a)(2) is a modified version of Section 337 of the Revenue Act of 1918.

The Court below also erred in concluding that the omission from subparagraph (B) of the words "research, or development of tangible property", and the grouping in subparagraph (C), as a separate class, of income resulting from "the sale of patents, formulae or processes," manifest an intent to confine the meaning of the word "discovery" to its extractive sense.

By taking out "research, or development of tangible property", Congress did not thereby exclude "invention", for the word "research" is not synonymous with "invention".

In *United States* v. *Dubilier Condenser Corporation*, 49 F(2d) 306 (D. Del. 1931); aff'd 59 F(2d) 381 (CA 3rd, 1932); aff'd 289 U. S. 178 (1933), "research" was carefully distinguished from "invention":

> "• • • 'Research' has been defined as the 'endeavor to discover, to develop, and to verify knowledge', and 'careful or critical inquiry or examination in seeking facts or principles'. *While invention may and usually does presuppose research, research certainly does not usually involve or result in invention. To say that a person engaged in 'research' work is necessarily engaged in 'inventive work' is putting an unwarranted construction upon the word*

*'research', not justified by common knowledge or experience."* (49 F(2d) 306, 312; italics supplied).[17]

The House and Senate Committee reports[18] stated that the purpose of the deletion of "research, or development of tangible property" was to plug "a potential loophole of major dimensions" found to exist in the old law. No reason exists for concluding that Congress intended such deletion to effect any greater change than was necessary to accomplish its stated purpose. Such purpose was completely served by excluding income resulting from research and development that failed to achieve a genuine discovery which substantially advanced the art.[19]

The only need from the administrative point of view was to exclude income resulting from research and development where the inability to relate such income directly to the research or development could create the potential loophole. In the case of the discovery of a new basic invention no such potential loophole could exist, since the income derived therefrom is directly and necessarily related to such discovery.[20]

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17. The opinion of the Court of Appeals in the cited case stated: "* * * We find nothing in the record or in the common meaning of the two words to suggest this identity * * *" (59 F. (2d) 381, 385).

18. H.R. Rep. No. 3142, 81st Cong., 2d Sess., December 2, 1950, 1951-1 Cum. Bull. 187, 195; Senate Rep. No. 2679, 81st Cong., 2d Sess., December 18, 1950, 1951-1 Cum. Bull. 240, 249.

19. So construed, the change in the law affected the major area of research in industry—the area connected with changes in style, design, model or product and with normal mechanical improvements in process or products, none of which involves invention in the order of discovery.

20. The Tax Court found that petitioner's income from the Polaroid Land Process resulted entirely from its capacity to produce a picture in a minute, and that absent such capacity there would have been no income from such source whatsoever (R. 9, fol. 11). The Tax Court further found that the exhibition of 3-D motion pictures would not have been commercially practicable had petitioner's synthetic polarizer not been available, and that no non-infringing material for this purpose was on the market (R. 5-6, fol. 7).

This proper interpretation of the Congressional intent was made by the Court of Appeals for the Seventh Circuit in *G. D. Searle & Co.* v. *Jarecki*, 274 F(2d) 129, 131 (CA 7th 1960).

The only effect of the change in classification of income resulting from the sale of patents, formulae or processes was to alter the standard for the determination of abnormality. For that purpose under the prior law, such income had been grouped with other income in the same statutory class. Under Section 456(a)(2)(C), the abnormality was determinable by reference to the income from that source alone. There is no statement in any Committee report which supports the conclusion of the Court below that the grouping of this income as a separate class of income under subparagraph (C) was intended to affect the meaning of the word "discovery" in subparagraph (B). Had Congress any such intent, the likelihood is that it would have said so in its Committee reports.

The opinion of the Court below adverts to the substitution in the sections of the Korean War Act dealing with relief for abnormalities occurring during the base period, of a more automatic approach for the discretionary approach of Section 722 of the Second World War Act.[21] This substitution has no bearing on the method provided by the statutes for relief for abnormalities in income during the taxable year. As expressly stated in paragraph (e) of Section 456, the section has no effect upon the computation of base period net income. Moreover, the provisions of paragraphs (b), (c) and (d), which define the method for attribution of net abnormal income to other years and for computation of the tax, if net abnormal income is found to exist under paragraph (a), manifest no change of approach, since the provisions of such para-

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21. R. 64, footnote 7.

graphs, except for inconsequential word changes, are identical to the comparable paragraphs of Section 721.[22]

We respectfully submit that petitioner's income from the Polaroid Land Process and the 3-D Synthetic Polarizer falls squarely within the class of income described in Section 456(a)(2)(B) as income resulting from "discovery".

## II

**If petitioner's income from the Polaroid Land Process and the 3-D Synthetic Polarizer was not entitled to be classified as "discovery" income under subparagraph (B) of Section 456(a)(2), such income was entitled to classification by the Secretary pursuant to the last sentence of Section 456(a)(2).**

The last sentence of Section 456(a)(2) reads as follows:

> "The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

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22. The changes made with respect to abnormalities in the base period in Sections 442-447 of the Korean War Act from the provisions of Section 722 of the Second World War Act were in the method of computing the relief and not in the factors of qualification for such relief. All but one of the qualifying factors under Section 722 were qualifying factors under the Korean War Act provisions. See Senate Rep. No. 2679, 81st Cong., 2d Sess., December 18, 1950, 1951-1 Cum. Bull. 240 at 252; H.R. Rep. No. 3142, 81st Cong., 2d Sess., December 2, 1950, 1951-1 Cum. Bull. 187 at 198.

The standardized treatment provided in Section 721 for computing the relief for abnormalities in income during the taxable year made such relief automatic (*United States* v. *Koppers Co.*, 348 U. S. 254, 267 (1955); *American Coast Line, Inc.* v. *Commissioner of Internal Revenue*, 159 F(2d) 665, 667 (CA 2d 1947); *Pohatcong Hosiery Mills, Inc.* v. *Commissioner of Internal Revenue*, 162 F(2d) 146, 148 (CA 3rd 1947)).

Such provision, we submit, required the Secretary to classify petitioner's income from its basic scientific discoveries.

The legislative history of this last sentence demonstrates that Congress intended thereby to extend the scope of the section to other types of income, which, in the context of the facts which might exist in the taxable year, were as abnormal as the described types.

As originally enacted, Section 721(a)(2) of the Second World War Act provided relief only with respect to six specifically enumerated classes.[23] In the Excess Profits Tax Amendments of 1941[24], the provision was broadened by the addition of the sentence: "The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary." The reason for such amendment was stated as follows:

> "Section 721 of the present law provides relief with respect to certain abnormalities in income in the taxable period. These abnormalities, six in number, are specifically described * * *. It is believed advisable to extend the principle of this section to any abnormal item of income. As the types of abnormal income that may occur cannot be predicted in advance, adequate relief can only be granted by thus extending the scope of this section." (H.R. Rep. No. 146, 77th Cong., 1st Sess., "Excess Profits Tax Amendments of 1941", 1941-1 Cum. Bull. 550, 55[illegible]

This provision for classification of other classes of income was carried over into Section 456(a)(2) in vir-

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23. Senate Rep. No. 2114, 66th Cong., 3d Sess., September 11, 1940, 1940-2 Cum. Bull. 528, 533.

24. Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17, 22.

tually the same language, but only after Congress had deliberated again as to the advisability of restricting abnormal income to the classes expressly defined, and of recognizing no other type of income as abnormal.

The Korean War Act originated in the House of Representatives as H.R. 9827. Section 454(A)(2) of that bill set forth the classes of income described in paragraph (2) of Section 456(a), as finally enacted, including the last sentence providing for additional classifications by the Secretary. The Senate Finance Committee proposed an amendment (Amendment No. 201) to strike out this final sentence. In conference, however, the Senate receded and agreed to the wording initially used in the House bill (H.R. Rep. No. 3231, Conference Report, 81st Cong., 2nd Sess., December 22, 1950, 1951-1 Cum. Bull. 268, 277).[25]

The determination of the Court below that the provisions of the last sentence of Section 456(a)(2) gave the Secretary the discretion but not the obligation to provide additional classifications of income, not only ignores the deliberate intention of Congress, manifest from the legislative history, of extending the scope of the section, but also raises grave doubts as to its constitutionality. So construed, this provision would constitute an improper delegation by Congress of its essential legislative functions in violation of Article I, Sections 1 and 8 of the

25. The summary of H.R. 9827 as agreed to by the Conferees, prepared by the staff of the Joint Committee, added as item 5 to a numerical listing of the four classes described in subparagraph (A)-(D) of Section 456(a)(2) "income of other classes permitted under regulations prescribed by the Secretary". (Summary of H.R. 9827, "The Excess Profits Tax Act of 1950 as Agreed to by the Conferees, prepared by the Joint Committee on Internal Revenue Taxation, December 1950, p. 9.)

Constitution, for nowhere in the statute are there any standards, express or implied, for determining which additional classes of income the Secretary may elect to classify or refuse to classify. *Panama Refining Co.* v. *Ryan,* 293 U. S. 388, 421, 428, 429, 434 (1935).

The words "any class" in this provision of the statute establish that the Secretary was under a mandate to classify all income and that only the designation of the class in which a particular type of income was to be placed was left to the Secretary's discretion.[26] So construed, there would be no question as to its constitutionality. *United States ex rel. Attorney General* v. *Delaware & Hudson Company,* 213 U. S. 366, 407 (1909); *Knights Templars' and Masons' Life Indemnity Company* v. *Jarman,* 187 U. S. 197, 205 (1902).

In discharge of his administrative duty, the Secretary issued regulations to the effect that if a taxpayer had income which did not fit into one of the four classes enumerated in the statute, the taxpayer should group such income in such class similar to one of the specified classes as was reasonable in a business of the type conducted by it and as was appropriate in the light of its business experience and accounting practice (Regulations 130, Section 40.456-2(b) (1951) Appendix pp. 7a-8a). Pursuant to this instruction, petitioner grouped its income from the Polaroid Land Process and the 3-D Synthetic Polarizer in a class similar to the class set forth in subparagraph (B)

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26. In Rabkin & Johnson, Excess Profits Tax (Matthew Bender & Co. 1957) Section 81.05, it is stated with respect to what is excluded under Section 466 from the impact of the excess profits tax:

> "* * * The inclusion of the quoted sentence in the final statute indicates clearly that any 'class' of income which qualifies under the statutory formula may be excluded, even though it does not fall within one of the designated classes."

of Section 456(a)(2), as income resulting from what, in the context of the type of business conducted by petitioner, constituted "discovery".

The determination of the Court below that "If 'discovery' relates to mining and natural resources, taxpayer's classification is not 'similar'" (R. 69, fol. 75), involves a misunderstanding of what the regulation requires to be similar. A difference in the type of business is assumed; only the source of income must be "similar" in the light of taxpayer's type of business.

We further submit that the Court below erred in concluding that the regulations specifically state that income of this class is not subject to relief (R. 69, fols. 75-76).

Regulations 130, Section 40.456-2(b) (1951) provides:

> "Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)."

It is apparent from the first word of the third sentence of the regulations—"However"—that the third sentence must be read as a qualification of the second sentence. The third sentence[27] clearly states that Section 456 is applicable to "such income" (i.e. the income resulting from the sale of tangible property arising out of research and development, which is the subject matter of the second sentence), if the income is otherwise properly includible within a class of income to which such section is applicable (i.e. the classes specifically described in the statute and the additional classes provided for in the first sentence of the regulation).[28]

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27. The third sentence was added to the regulations by the Treasury Department for the express purpose of making clear that there was no intention to exclude, under certain circumstances, income from the sale of tangible property arising out of research and development.

As originally proposed and published in the Federal Register on December 4, 1952 (17 F.R. 10973), the regulation provided:

> "Income from the sale of tangible property, however, even though such income may arise out of research and development which has extended over a period of more than 12 months is not income to which section 456 is applicable. Such income from the sale of tangible property may not constitute or be included in any class of income for purposes of section 456(b)."

This proposed regulation was abandoned in favor of the one finally adopted, which, in the added third sentence, recognized that income from the sale of tangible property arising out of research and development falls within Section 456 if the income is otherwise properly includible within a class of income to which such section is applicable (T.D. 6026, 1953-2 Cum. Bull. 235).

28. The provision in the first sentence making taxpayer's grouping of income subject to the approval of the Commissioner on the examination of taxpayer's return, gave the Commissioner the authority to review whether the grouping of such income into a particular class was proper. To construe this provision as giving any greater authority to the Commissioner would make it invalid for the reasons set forth in the text.

Under this proper interpretation of the regulation, we submit, even if the word "discovery" in subparagraph (B) of Section 456(a)(2) were limited to the discoveries of the mining industries, petitioner's income from its basic scientific discoveries was properly grouped in a class similar to the class set forth in subparagraph (B). We further submit that if the regulation is to be construed as denying to a taxpayer relief from abnormal income resulting from its basic scientific discoveries merely because research or development may have been factors which contributed to the discoveries, such regulation must be rejected as invalid as reducing the area of relief provided in the statute by the last sentence of subparagraph (2) of Section 456(a). Compare *G. D. Searle & Co.* v. *Jarecki*, 283 F(2d) 129, 131 (CA 7th 1960); *Morrill* v. *Jones*, 106 U. S. 466 (1883).

## III

**The conclusion that petitioner's income from the Polaroid Land Process and the 3-D Synthetic Polarizer constitutes abnormal income under Section 456 is confirmed by the purpose underlying the Korean War Act.**

The purpose of the Korean War Act was to tax the additional profits resulting from the wartime economy.

As was stated in House of Representatives Report No. 3142, 81st Congress, 2nd Session (1950) (1951-1 Cum. Bull. at p. 187):

> "One of the main objectives in imposing an excess profits tax is to reach corporate profits which have been swollen by the increased tempo of the economy. An excess profits tax selects for additional tax those

> corporations whose profits are higher than they probably would have been in the absence of hostilities and a large military budget * * *".

The purpose of the relief provisions in such a law with respect to abnormal income is to exempt abnormal income arising solely from a corporation's internal achievements and not from the stimulus of the war economy.[29] *Soabar Company* v. *Commissioner*, 7 TC 89, 96 (1946).

Petitioner's profits during the tax years were not "higher than they probably would have been in the absence of hostilities and a large military budget". Its income from the Polaroid Land Process and the 3-D Synthetic Polarizer was not the additional income which the Korean War Act was designed to reach. On the contrary, its income from the Polaroid Land Process resulting, as found by the Tax Court, "entirely from its capacity to produce a picture in a minute" (R. 9 fol. 11), and its income from the 3-D Synthetic Polarizer arising, as found by the Tax Court, entirely from its capacity to create, in the exhibition of 3-D motion pictures, the illusion of the three dimensions, which could not have been accomplished without it (R. 5-6, fol. 7), were not attributable to any stimulus of the war economy. Abnormal income from such sources constituted the very kind of abnormal income for which Section 456 was designed to afford relief.

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29. In the formulation of our excess profits tax laws since the enactment of the first such law to meet the emergencies of the First World War, the purpose of Congress to achieve an equitable distribution of the additional tax burden has been as compelling as its aim to provide adequate revenue. H.R. Rep. No. 767, 65th Cong., 2d Sess. "Revenue Bill and Report", Document No. 1267, p. 2, September 3, 1918; H.R. Rep. No. 146, 77th Cong., 1st Sess., "Excess Profits Tax Amendments of 1941", p. 2, February 27, 1941, 1941-1 Cum. Bull. 550; H.R. Rep. No. 3142, 81st Cong., 2d Sess., "Excess Profits Tax Act of 1950", 1951-1 Cum. Bull. 187, 188.

That a statute is to be construed in the light of its purpose is a well recognized rule of statutory construction. *Central Bank* v. *United States*, 345 U. S. 639, 646 (1953); *United States* v. *Sullivan*, 332 U. S. 689, 693 (1948).

We respectfully urge that to interpret the word "discovery" in subparagraph (B) of Section 456(a)(2) as confined only to the extractive industries, and to deny to income resulting from basic scientific discoveries classification under the broad provisions of the last sentence of paragraph (2), as the Court below has done, ignores the purposes of the Korean War Act and of its relief provision for abnormal income. Such interpretation penalizes enterprises which have encouraged their most talented and resourceful people to discover breakthrough inventions. Such interpretation saddles these enterprises with an additional tax burden simply because of the fortuity that the discoveries came to fruition in an excess profits tax year. In this era, when the encouragement of scientific discoveries is of vital importance to the nation's well-being, when the need for attracting and inspiring the nation's gifted youth to scientific endeavor is one of the major concerns of our government, when the survival of our civil, political and economic way of life may depend upon building strength through invention, the efforts and achievements of our scientists are among our major natural resources. During the war period in which the statute was enacted, the encouragement of basic scientific discovery was at least as essential to the nation's interests as the encouragement of the discovery of sources of ores and oils. In that context, it is difficult to conceive that Congress intended to deny to a basic scientific "discovery" the tax relief afforded to the "discovery" of oil and minerals.

## CONCLUSION

**For the reasons stated, it is respectfully submitted that the judgment of the Court below should be reversed and the case remanded to the Tax Court for the fixing of petitioner's net abnormal income and the attribution thereof to prior years, in accordance with the Stipulation herein.**

Dated: December 2, 1960.

Respectfully submitted,

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# APPENDIX

## United States Constitution

Article 1 Section 1:

All legislative Powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.

Article 1 Section 8:

The Congress shall have Power • • •

To promote the Progress of Science and useful Arts, by securing for Limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries; • • •

To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.

## STATUTE INVOLVED

### Section 456 of the Internal Revenue Code of 1939 (26 U.S.C., 1952 ed., Section 456)

SEC. 456. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) *Definitions.* For the purposes of this section—

(1) *Abnormal income.* The term 'abnormal income' means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally

derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.* Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

(3) *Net abnormal income.* The term 'net abnormal income' means the amount of the abnormal income less, under regulations prescribed by the Secretary, (A) 115 per centum of the average

amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any costs or deductions relating to such abnormal income, allowable in determining the normal-tax net income for the taxable year, as the excess of the amount of such abnormal income over 115 per centum of such average amount bears to the amount of such abnormal income.

(b) *Amount attributable to other years.* The amount of the net abnormal income that is attributable to any previous or future taxable year or years, shall be determined under regulations prescribed by the Secretary. In the case of amounts otherwise attributable to future taxable years, if the taxpayer either transfers substantially all its properties or distributes any property in complete liquidation, then there shall be attributable to the first taxable year in which such transfer or distribution occurs (or if such year is previous to the taxable year in which the abnormal income is includible in gross income, to such latter taxable year) all amounts so attributable to future taxable years not included in the gross income for a previous taxable year.

(c) *Computation of tax for current taxable year.* The tax under this subchapter for the taxable year, in which the whole of such abnormal income would without regard to this section be includible, shall not exceed the sum of:

(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

(2) The aggregate of the increase in the tax under this subchapter for the taxable year (com-

puted under paragraph (1)) and for each previous taxable year which would have resulted if, for each previous taxable year to which any portion of such net abnormal income is attributable, an amount equal to such portion had been included in the gross income for such previous taxable year.

(d) *Computation of tax for future taxable year.* The amount of the net abnormal income attributable to any future taxable year shall, for the purposes of this subchapter, be included in the gross income for such taxable year.

(1) The tax under this subchapter for such future taxable year shall not exceed the sum of—

(A) the tax under this subchapter for such future taxable year computed without the inclusion in gross income of the portion of such net abnormal income which is attributable to such year; and

(B) the decrease in the tax under this subchapter for the previous taxable year in which the whole of such abnormal income would, without regard to this section, be includible which resulted by reason of the computation of such tax for such previous taxable year under the provisions of subsection (c); but the amount of such decrease shall be diminished by the aggregate of the increases in the tax under this subchapter for the future taxable year as computed under subparagraph (A) and for the taxable years intervening between such previous taxable year and such future taxable year which have resulted because of the inclusion of the portions of such net abnormal income attributable to such intervening years in the gross income for such intervening years.

(2) If, in the application of subsection (c), net abnormal income from more than one taxable year is attributable to any future taxable year, paragraph (1) of this subsection shall be applied with respect to such future taxable year in the order of the taxable years from which the net abnormal income is attributable beginning with the earliest, as if the portion of the net abnormal income from each such year was the only amount so attributable to such future taxable year, and (except in the case of the portion for the earliest previous taxable year) as if the tax under this subchapter for the future taxable year was the tax determined under paragraph (1) with respect to the portion for the next earlier previous taxable year.

(3) If in the application of paragraph (1) to any future taxable year it is determined that the decrease in tax computed under paragraph (1) (B) with respect to the net abnormal income, a portion of which is included in the gross income for the future taxable year, does not exceed the aggregate of the increases in tax computed under paragraph (1) (B) with respect to such net abnormal income, then the portions of such net abnormal income attributable to taxable years subsequent to such future taxable year shall not be included in the gross income for such subsequent taxable year. For the purpose of computing the tax under this subchapter for a taxable year subsequent to the future taxable year, the portion of net abnormal income attributable to the future taxable year shall not be included in the gross income for such future taxable year to the extent that the inclusion of such portion of net abnormal income in the gross income for such future taxable year did not result in an increase in tax for such future taxable year by reason of the provisions of paragraph (1).

(e) *Application of section.* This section shall be applied only for the purpose of computing the tax under this subchapter as provided in subsections (c) and (d), and shall have no effect upon the computation of base period net income. For the purposes of subsections (c) and (d)—

(1) Net abnormal income means the aggregate of the net abnormal income of all classes for one taxable year.

(2) Under regulations prescribed by the Secretary, the tax under this subchapter for previous taxable years shall be computed as if the portions of net abnormal income for each previous taxable year for which the tax was computed under this section were included in the gross income for the other previous taxable years to which such portions were attributable.

(3) If both subsections (c) and (d) are applicable to any current taxable year, subsection (d) shall be applied without regard to subsection (c) and subsection (c) shall be applied as if the tax under this subchapter, except for subsection (c), was the tax computed under subsection (d) and as if the gross income and the other amounts necessary to determine the adjusted excess profits net income were those amounts which would result in the tax computed under subsection (d)."

## TREASURY REGULATIONS INVOLVED

"Reg. 130, Sec. 40.456-1. *Abnormalities in income in taxable year.*—(a) Section 456 applies if abnormal income (as defined in section 456(a)) for any excess profits tax taxable year is attributable to other taxable years. The term 'abnormal income' means income of any class de-

scribed in section 40.456-2 includible in the gross income of the taxpayer for any excess profits tax taxable year (1) if it is abnormal for the taxpayer to derive gross income of such class, or (2) if the taxpayer normally derives gross income of such class but the amount of such income of such class is in excess of 115 percent of the average amount of the gross income of the same class determined for the four previous taxable years or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence. It is abnormal for a taxpayer to derive income of any class only if the taxpayer had no gross income of that class for the four previous taxable years. For the purpose of determining abnormal income under this paragraph the gross income of the class for the previous taxable years is not to be increased or decreased by any allocation under the provisions of section 456. Abnormal income is to be determined by considering classes of income, and not merely particular items."

(b) • • •.

"Reg. 130, Sec. 40.456-2. *Classification of income.* (a) Section 456(a) (2) (A), (B), (C), and (D) sets forth four separate classes of income. All the income which reasonably is classifiable in more than one class shall be classified under the one which the taxpayer irrevocably elects. Such election shall be made in the manner prescribed in section 40.456-3. The classification of income for any year must be consistent with the classification made under section 456 for previous years. The classification must also be consistent with any classification made in applying section 433(b) (9) to the taxpayer.

(b) Other income, not within a class described in subparagraphs (A)-(D) of section 456(a) (2), to which section 456 is applicable may be grouped by the taxpayer,

subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)."

## OTHER STATUTORY REFERENCES

**Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.)**

SEC. 433. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Ending After June 30, 1950.*—The excess profits net income for any taxable year ending after June 30, 1950, shall be the normal-tax net income, as defined in section 13(a)(2), for such year increased or decreased by the following adjustments:

(1) *Adjustments.*—

* * *

(I) *Non-taxable income of certain industries with depletable resources.*—In the case of a producer of minerals, or a producer of logs or lumber from a timber block, or a lessor of mineral property, or a timber block, as defined in section 453, there shall be excluded non-taxable income from exempt excess

output of mines and timber blocks provided in section 453; in the case of a natural gas company, as defined in section 453, there shall be excluded nontaxable income from exempt excess output provided in section 453; and in the case of a producer of minerals, or a producer of logs or lumber from a timber block, there shall be excluded nontaxable bonus income provided in section 453. In respect to nontaxable bonus income provided in section 453(c), a corporation described in section 453(c)(2) shall be deemed a producer of minerals for the purposes of this subparagraph;

• • •

(P) *Payments to encourage exploration, development and mining for defense purposes.*—An amount paid to a taxpayer by the United States (or any agency or instrumentality thereof), whether by grant or loan, and whether or not repayable, for the encouragement of exploration, development or mining of critical and strategic minerals or metals pursuant to or in connection with any undertaking approved by the United States (or any of its agencies or instrumentalities) and for which an accounting is made or required to be made to an appropriate governmental agency, and the forgiveness or discharge of any such amount, shall be excluded in computing excess profits net income; and any expenditures (other than expenditures made after the repayment of such grant or loan) attributable to such grant or loan shall not be deductible by the taxpayer as an expense nor increase the basis of the taxpayer's property either for determining gain or loss on sale, exchange, or other disposition or for computing depletion or depreciation, but upon the repayment of any portion of any such grant or loan which has been expended in accordance with the terms thereof such deductions and such increase in basis shall to the extent of such repayment be allowed as if made at the time of such repayment;

• • •

SEC. 443. AVERAGE BASE PERIOD NET INCOME —CHANGE IN PRODUCTS OR SERVICES.

(a) *In General.*—If a taxpayer which commenced business on or before the first day of its base period establishes with respect to any taxable year that—

(1) During so much of its three immediately preceding taxable years as falls within the 36-month period ending on the last day of its base period, there was a substantial change in the products or services furnished by the taxpayer,

(2) More than 40 per centum of its gross income or 33 per centum of its net income for such taxable year is attributable to one or more of the new products or services, and

(3) Its average monthly excess profits net income (determined under subsection (e)) for such taxable year exceeds 125 per centum of its average monthly excess profits net income (determined under subsection (e)) for the taxable years ending within its base period and prior to the taxable year in which the first change to which gross income is attributed for the purpose of this subsection occurred,

then, in computing its excess profits credit for taxable years under this subchapter which end on or after the last day of the earliest taxable year with respect to which the requirements of paragraphs (1), (2), and (3) are satisfied, its average base period net income determined under this section shall be the amount computed under subsection (b).

• • •

SEC. 450. CORPORATIONS ENGAGED IN MINING OF STRATEGIC MINERALS.

(a) *Exemption from tax.* In the case of any domestic corporation engaged in the mining of a strategic mineral,

the portion of the adjusted excess profits net income attributable to such mining in the United States shall be exempt from the tax imposed by this subchapter. The tax on the remaining portion of such adjusted excess profits net income shall be an amount which bears the same ratio to the tax computed without regard to this section as such remaining portion bears to the entire adjusted excess profits net income.

(b) *Definitions.* For the purposes of this section—

(1) the term "strategic mineral" means antimony, chromite, bauxite, manganese, nickel, platinum (including the platinum group metals), quicksilver, sheet mica, tantalum, tin, tungsten vanadium, fluorspar, flake graphite, perlite, long-fibre asbestos in the form of amosite, chrysotile or crocidolite, beryl, cobalt, columbite, corundum, diamonds, kyanite (if equivalent in grade to Indian kyanite), molybdenum, monazite, quartz crystals, and uranium, and any other mineral which the certifying agency has certified to the Secretary as being essential to the defense effort of the United States and as not having been normally produced in appreciable quantities within the United States.

(2) The term "certifying agency" means the department, official, corporation, or agency utilized or created to carry out the authority of the President under section 303(a) of the Defense Production Act of 1950 to make provision for the encouragement of exploration, development, and mining of critical and strategic minerals and metals.

(c) *Certification during taxable year of taxpayer.* In determining under subsection (a) the portion of the adjusted excess profits net income which is attributable to the mining of a mineral which is a strategic mineral by reason of a certification made during the taxable year, such

portion shall be an amount which bears the same ratio to the portion of the adjusted excess profits net income, determined without regard to this subsection, attributable to such mining during the entire taxable year as the number of days for which the taxpayer held the mineral property during the taxable year and after the date of the making of the certification bears to the number of days for which the taxpayer held the property during such taxable year.

(d) *Application of section to lessor.* In the case of a mining property operated under a lease, income attributable to such property derived by a lessor corporation shall, for the purposes of this section, be considered to be income of a corporation engaged in mining.

SEC. 453. NONTAXABLE INCOME FROM CERTAIN MINING AND TIMBER OPERATIONS, AND FROM NATURAL GAS PROPERTIES.

(a) *Definitions.* For the purposes of this section and section 433(a)—

(1) *Producer; lessor; natural gas company.* The term "producer" means a corporation which extracts minerals from a mineral property, or which cuts logs from a timber block, in which an economic interest is owned by such corporation. The term "lessor" means a corporation which owns an economic interest in a mineral property or a timber block, and is paid in accordance with the number of mineral units or timber units recovered therefrom by the person to which such property or block is leased. The term "natural gas company" means a corporation engaged in the withdrawal, or transportation by pipe line, of natural gas.

(2) *Mineral unit, natural gas unit, and timber unit.* The term "mineral unit" means a unit of

metal, coal, or nonmetallic substance in the minerals recovered from the operation of a mineral property. The term "natural gas unit" means a unit of natural gas sold by a natural gas company. The term "timber unit" means a unit of timber recovered from the operation of a timber block.

(3) *Excess output.* The term "excess output" means the excess of the mineral units, natural gas units, or timber units for the taxable year over the normal output.

(4) *Normal output.* The term "normal output" means the average annual mineral units, or the average annual timber units, as the case may be, recovered in the taxable years beginning after December 31, 1945, and not ending after June 30, 1950, (hereinafter in this section called "normal period"), of the person owning the mineral property or the timber block, (whether or not the taxpayer). The term "normal output", in the case of a natural gas company, means the average annual natural gas units sold in the taxable years beginning after December 31, 1945, and not ending after June 30, 1950, (hereinafter in this section called "normal period"), of the person owning the natural gas property (whether or not the taxpayer). The average annual mineral units, natural gas units, or timber units shall be computed by dividing the aggregate of such mineral units, natural gas units, or timber units for the normal period by the number of months for which the mineral property, natural gas property, or timber block was in operation during the normal period and by multiplying the amount so ascertained by twelve. In any case in which the taxpayer establishes, under regulations prescribed by the Secretary, that the operation of any mineral property, natural gas property, or timber block is normally prevented for a specified period each year by physical events outside the

control of the taxpayer, the number of months during which such mineral property, natural gas property, or timber block is regularly in operation during a taxable year shall be used in computing the average annual mineral units, natural gas units, or timber units, instead of twelve. Any mineral property, natural gas property, or timber block, which was in operation for less than six months during the normal period, shall, for the purposes of this section, be deemed not to have been in operation during the normal period.

(5) *Natural gas property.* The term "natural gas property" means the property of a natural gas company used for the withdrawal, storage, and transportation by pipe line, of natural gas, excluding any part of such property which is an emergency facility under section 124A.

(6) *Mineral property.* The term "mineral property" means a mineral deposit, the development and plant necessary for the extraction of the deposit, and so much of the surface of the land as is necessary for purposes of such extraction.

(7) *Minerals.* The term "minerals" means ores of the metals, coal, and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gravel, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand, shell, silica, slate, soapstone, soda, sulphur, and talc.

(8) *Timber block.* The term "timber block" means an operation unit which includes all the taxpayer's timber which would logically go to a single given point of manufacture.

(9) *Normal unit profit.* The term "normal unit profit" means the average profit for the normal

period per mineral unit for such period, determined by dividing the net income with respect to minerals recovered from the mineral property (computed with the allowance for depletion computed in accordance with the basis for depletion applicable to the current taxable year) during the normal period by the number of mineral units recovered from the mineral property during the normal period.

(10) *Alternative computation.* In any case in which more than one mineral property is owned or operated by a lessor or producer as defined in (a) (1) of this section, such lessor or producer may treat the mineral properties as one property for purposes of computing exempt excess output under this section.

(11) *Estimated recoverable units.* The term "estimated recoverable units" means the estimated number of units of metal, coal, or nonmetallic substances in the estimated recoverable minerals from the mineral property at the end of the taxable year plus the excess output for such year. All estimates shall be subject to the approval of the Secretary, the determinations of whom for the purposes of this section, shall be final and conclusive.

(12) *Exempt excess output.* The term "exempt excess output" for any taxable year means a number of units equal to the following percentages of the excess output for such year:

100 per centum if the excess output exceeds 50 per centum of the estimated recoverable units;

95 per centum if the excess output exceeds 33-1/3 but not 50 per centum of the estimated recoverable units;

90 per centum if the excess output exceeds 25 but not 33-1/3 per centum of the estimated recoverable units;

85 per centum if the excess output exceeds 20 but not 25 per centum of the estimated recoverable units;

80 per centum if the excess output exceeds 16-2/3 but not 20 per centum of the estimated recoverable units;

60 per centum if the excess output exceeds 14-2/7 but not 16-2/3 per centum of the estimated recoverable units;

40 per centum if the excess output exceeds 12-1/2 but not 14-2/7 per centum of the estimated recoverable units;

30 per centum if the excess output exceeds 10 but not 12-1/2 per centum of the estimated recoverable units;

20 per centum if the excess output exceeds 5 but not 10 per centum of the estimated recoverable units.

(13) *Unit net income.* The term "unit net income" means the amount ascertained by dividing the net income (computed with the allowance for depletion) from the coal, ore, sulphur, potash, metallurgical grade limestone, chemical grade limestone, or timber recovered from the mineral property, or timber block, as the case may be, during the taxable year by the number of units of such mineral or timber recovered from such property in such year. In respect of a natural gas property, the term "unit net income" means the amount ascertained by dividing the net income, computed in accordance with regulations prescribed by the Secretary, from such property during the taxable year by the number of natural gas units sold in such year.

(b) *Nontaxable income from exempt excess output.*

(1) *General rule.* For any taxable year for which the excess output of mineral property which was in operation during the normal period exceeds 5 per

centum of the estimated recoverable units from such property, the nontaxable income from exempt excess output for such year shall be an amount equal to the exempt excess output for such year multiplied by the normal unit profit, but such amount shall not exceed the net income (computed with the allowance for depletion) attributable to the excess output for such year.

(2) *Mines in operation during normal period.* For any taxable year, the nontaxable income from exempt excess output of a metal or coal mining property, or of a sulphur, potash, metallurgical grade limestone, or chemical grade limestone mineral property, which was in operation during the normal period shall be an amount equal to the excess output of such property for such year multiplied by one-half of the unit net income from such property for such year, or an amount determined under paragraph (1), whichever the taxpayer elects in accordance with regulations prescribed by the Secretary.

(3) *Timber properties.* For any taxable year, the nontaxable income from exempt excess output of a timber block which was in operation during the normal period shall be an amount equal to the excess output of such property for such year multiplied by one-half of the unit net income from such property for such year.

(4) *Certain properties not in operation during normal period.* For any taxable year, the nontaxable income from exempt excess output of a metal or coal mining property, of a sulphur, potash, metallurgical grade limestone, or chemical grade limestone mineral property, of a timber block, or of a natural gas property, which was not in operation during the normal period, shall be an amount equal to one-third of the net income for such taxable year (computed with the allowance for depletion) from

such property or timber block, as the case may be. For the purposes of the preceding sentence, a metal mining property shall be deemed not to have been in operation during the normal period if, during the period it was in production during 1946, 1947, 1948, and 1949, the aggregate gross income derived therefrom was less than the aggregate of the deductions (allowed under section 23 without regard to any net operating loss deduction) attributable to such property during such period of production.

(5) *Natural gas companies.* In the case of a natural gas company any of the natural gas property of which was in operation during the normal period, the nontaxable income from exempt excess output for any taxable year shall be an amount equal to the excess output for such year multiplied by one-half of the unit net income for such year.

(c) *Nontaxable bonus income.* The term "nontaxable bonus income" means the amount of the income derived from bonus payments made by any agency of the United States Government on account of the production in excess of a specified quota of:

(1) A mineral product or timber, the exhaustion of which gives rise to an allowance for depletion under section 23 (m), but such amount shall not exceed the net income (computed with the allowance for depletion) attributable to the output in excess of such quota; or

(2) A mineral product extracted or recovered from mine tailings by a corporation which owns no economic interest in the mineral property from which the ore containing such tailings was mined, but such amount shall not exceed the net income attributable to the output in excess of such quota.

(d) *Rule in case income from excess output includes bonus payment.* In any case in which the income attribut-

able to the excess output includes bonus payments (as provided in subsection (c)), the taxpayer may elect, under regulations prescribed by the Secretary, to receive either the benefits of subsection (b) or subsection (c) with respect to such income as is attributable to excess output above the specified quota.

SEC. 721. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) *Definitions.*—For the purposes of this section—

(1) *Abnormal income.*—The term "abnormal income" means income of any class includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income constituting an amount payable under a contract the performance of which required more than 12 months;[1] or

1. Subparagraph (B) of Section 721(a)(2) was made inapplicable to taxable years beginning after December 31, 1941, by Section 222(f) of the Revenue Act of 1942, which Act, by Section 222(d), added Section 736 to the Code to provide relief for taxpayers with income from long-term contracts.

(C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting; or

(E) In the case of a lessor of real property, income included in gross income for the taxable year by reason of the termination of the lease; or

(F) Income consisting of dividends on stock of foreign corporations, except foreign personal holding companies.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.

(3) *Net abnormal income.*—The term "net abnormal income" means the amount of the abnormal income less, under regulations prescribed by the Commissioner with the approval of the Secretary, (A) 125 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any direct costs or expenses, deductible in determining the normal-tax net income of the taxable year, through the expenditure of which such abnormal income was in whole or in part derived as the excess of the amount of such abnormal income over 125 per centum of such average amount bears to the amount of such abnormal income.

(b) *Amount Attributable to Other Years.*—The amount of the net abnormal income that is attributable to any previous or future taxable year or years shall be determined under regulations prescribed by the Commissioner with the approval of the Secretary. In the case of amounts otherwise attributable to future taxable years, if the taxpayer either transfers substantially all its properties or distributes any property in complete liquidation, then there shall be attributable to the first taxable year in which such transfer or distribution occurs (or if such year is previous to the taxable year in which the abnormal income is includible in gross income, to such latter taxable year) all amounts so attributable to future taxable years not included in the gross income of a previous taxable year.

(c) *Computation of Tax for Current Taxable Year.*—The tax under this subchapter for the taxable year, in which the whole of such abnormal income would without regard to this section be includible, shall not exceed the sum of:

(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

(2) The aggregate of the increase in the tax under this subchapter for the taxable year (computed under paragraph (1)) and for each previous taxable year which would have resulted if, for each previous taxable year to which any portion of such net abnormal income is attributable, an amount equal to such portion had been included in the gross income for such previous taxable year.

(d) *Computation of Tax for Future Taxable Year.*—The amount of the net abnormal income attributable to

any future taxable year shall, for the purposes of this subchapter, be included in the gross income for such taxable year.

(1) The tax under this subchapter for such future taxable year shall not exceed the sum of—

(A) the tax under this subchapter for such future taxable year computed without the inclusion in gross income of the portion of such net abnormal income which is attributable to such year, and

(B) the decrease in the tax under this subchapter for the previous taxable year in which the whole of such abnormal income would, without regard to this section, be includible which resulted by reason of the computation of such tax for such previous taxable year under the provisions of subsection (c); but the amount of such decrease shall be diminished by the aggregate of the increases in the tax under this subchapter for the future taxable year as computed under subparagraph (A) and for the taxable years intervening between such previous taxable year and such future taxable year which have resulted because of the inclusion of the portions of such net abnormal income attributable to such intervening years in the gross income for such intervening years.

(2) If, in the application of subsection (c), net abnormal income from more than one taxable year is attributable to any future taxable year, paragraph (1) of this subsection shall be applied with respect to such future taxable year in the order of the taxable years from which the net abnormal income is attributable beginning with the earliest, as if the portion of the net abnormal income from each such year was the only amount so attributable to such future taxable year, and (except in

the case of the portion for the earliest previous taxable year) as if the tax under this subchapter for the future taxable year was the tax determined under paragraph (1) with respect to the portion for the next earlier previous taxable year.

(3) If in the application of paragraph (1) to any future taxable year it is determined that the decrease in tax computed under paragraph (1)(B) with respect to the net abnormal income, a portion of which is included in the gross income for the future taxable year, does not exceed the aggregate of the increases in tax computed under paragraph (4)(B) with respect to such net abnormal income, then the portions of such net abnormal income attributable to taxable years subsequent to such future taxable year shall not be included in the gross income for such subsequent taxable years. For the purpose of computing the tax under this subchapter for a taxable year subsequent to the future taxable year, the portion of net abnormal income attributable to the future taxable year shall not be included in the gross income for such future taxable year to the extent that the inclusion of such portion of net abnormal income in the gross income for such future taxable year did not result in an increase in tax for such future taxable year by reason of the provisions of paragraph (1).

(e) *Application of Section.*—This section shall be applied only for the purpose of computing the tax under this subchapter as provided in subsections (c) and (d), and shall have no effect upon the computation of base period net income. For the purposes of subsections (c) and (d)—

(1) Net abnormal income means the aggregate of the net abnormal income of all classes for one taxable year.

(2) Under regulations prescribed by the Commissioner with the approval of the Secretary, the tax

under this subchapter for previous taxable years shall be computed as if the portions of net abnormal income for each previous taxable year for which the tax was computed under this section were included in the gross income for the other previous taxable years to which such portions were attributable.

(3) If both subsections (c) and (d) are applicable to any current taxable year, subsection (d) shall be applied without regard to subsection (c), and subsection (c) shall be applied as if the tax under this subchapter, except for subsection (c), was the tax computed under subsection (d) and as if the gross income and the other amounts necessary to determine the adjusted excess profits net income were those amounts which would result in the tax computed under subsection (d).

(f) *Abnormal Income From Exploration, etc.*—If, by reason of taking into account, in determining constructive average base period net income under section 722, exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months, such constructive average base period net income is higher than it would be without such taking into account, only such portion of the income in the taxable year resulting from such activity which is of a class described in subsection (a)(2)(C) as is attributable to another taxable year under this subchapter shall be deemed attributable to a year other than the taxable year.

**Revenue Act of 1918, c. 18, 40 Stat. 1057, 1093**

SEC. 327. That in the following cases the tax shall be determined as provided in section 328.

(a) Where the Commissioner is unable to determine the invested capital as provided in section 326;

(b) In the case of a foreign corporation;

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds respectively;

(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 percentum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917 and November 11, 1918, both dates inclusive.

Sec. 328. (a) In the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for

such year. In the case of a foreign corporation the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

In cases in which the tax is to be computed under this section, if the tax as computed without the benefit of this section is less than 50 percentum of the net income of the taxpayer, the installments shall in the first instance be computed upon the basis of such tax; but if the tax so computed is 50 percentum or more of the net income, the installments shall in the first instance be computed upon the basis of a tax equal to 50 percentum of the net income. In any case the actual ratio when ascertained shall be used in determining the correct amount of the tax. If the correct amount of the tax when determined exceeds 50 percentum of the net income, any excess of the correct installments over the amounts actually paid shall on notice and demand be paid together with interest at the rate of ½ of 1 percentum per month on such excess from the time the instalment was due.

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No. 169

# In the Supreme Court of the United States

OCTOBER TERM, 1960

POLAROID CORPORATION, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT*

## BRIEF FOR THE RESPONDENT

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# In the Supreme Court of the United States

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## BRIEF FOR THE RESPONDENT

### OPINIONS BELOW

The opinion of the Tax Court (R. 4–16) is reported at 33 T.C. 289. The opinion of the Court of Appeals (R. 59–71) is reported at 278 F. 2d 148.

### JURISDICTION

The judgment of the Court of Appeals was entered on May 3, 1960. (R. 71.) The petition for a writ of certiorari was filed on June 23, 1960, and was granted on October 10, 1960, 364 U.S. 813. (R. 72.) The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

### QUESTION PRESENTED

Whether the income received during the years 1951, 1952 and 1953 by the taxpayer from sales of Polaroid

Land cameras and equipment and stereo products resulted from "discovery" within the meaning of Section 456(a)(2)(B) of the Internal Revenue Code of 1939, so as to qualify for Korean War excess profits tax relief as "abnormal income."

## STATUTES AND REGULATIONS INVOLVED

Section 456 of the Internal Revenue Code of 1939 and other pertinent statutory and regulatory provisions are set forth in the Appendix to the Government's brief in the companion case, *Jarecki* v. *G. D. Searle & Co.*, No. 151.

## STATEMENT

This is a proceeding involving excess profits taxes for the years 1951–1953. (R. 5, 17.) The pertinent facts, as found by the Tax Court (R. 10) and as stated by the Court of Appeals (R. 59–60), may be summarized as follows:[1]

Between 1937 and 1948, the taxpayer was engaged primarily in research and development and in manufacturing and selling a variety of optical products in the field of light polarization (such as polarizing sunglasses and visors, polarizing camera filters, polarizing day-driving visors, and variable density windows). Edwin H. Land, its president, was also its director of research. (R. 5.)

In November 1948, the taxpayer began to market (R. 7) the so-called "Polaroid Land equipment." This equipment consisted of a camera and photographic film, both invented by Land, which produced

[1] The facts were developed primarily by stipulation (R. 53–58) and a number of exhibits (unprinted) attached thereto.

a finished dry positive print directly from the camera within 60 seconds after the picture was snapped. (R. 8.)[2] Taxpayer's first patent in the "Picture in a Minute" field was issued in 1948, and numerous subsequent patents have been issued to it. (R. 8.)[3] The sales of Polaroid Land equipment resulted entirely from the equipment's capacity to produce a picture immediately. If the equipment had not made an instantaneous positive print, there would have been no demand for the camera or photographic pack. (R. 9.)

Land also had invented a synthetic light polarizer, and incorporated it in "viewers" used by audiences in viewing 3-dimensional (3–D) motion pictures. The exhibition of 3–D motion pictures (which occurred in 1952 and 1953) would not have been commercially practicable without the taxpayer's synthetic polarizer (called "stereo"), since the latter was necessary to give the 3–D illusion. The taxpayer owned three patents on this polarizer. No non-infringing material was on the market. (R. 5–6.)

During the years 1944 through 1953, the taxpayer, in the invention and development of Polaroid Land cameras and photographic packs and accessories, incurred annual expenses ranging from roughly

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[2] The Tax Court's description of the nature and novelty of Land's invention (R. 7–8) is not disputed. These details are omitted here since they do not bear on the question before the Court.

[3] At the end of 1953, 118 patents had issued on the Polaroid Land equipment and 91 additional applications were pending. At the end of 1958, 238 patents had issued and 202 additional applications were pending. In 1954, the Patent Office created a separate subclass for patent applications in the Polaroid Land equipment field. (R. 8.)

$7,000 to $388,000. (R. 9.) Its invention and developmental expenses on "stereo" ranged from $9,000 to $172,000 during the years 1943–1953. (R. 6.) During the taxable years involved, the taxpayer derived net income from its sales of Polaroid Land equipment and of "stereo" products (R. 6, 9).[4] This income is the subject of the present controversy.

Sustaining (R. 4, 10–14) the Commissioner's determination (R. 21–34), the Tax Court concluded that the taxpayer's income from the sales of Polaroid Land equipment and stereo products during the years in question was income from sales of tangible property arising out of research and development (R. 6, 9), and was not "abnormal income" under Section 456. (R. 9). It held specifically that such income did not constitute income from "exploration, discovery, or prospecting" within the meaning of Section 456(a)(2) of the Code (R. 10–14),[5] that it was not "abnormal income" within the Commissioner's Regulations thereunder (R. 14),[6] and that accordingly the taxpayer could not qualify for Korean War excess profits tax relief under Section 456.

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[4] This income, for the years 1951, 1952 and 1953, amounted to $1,229,412, $1,465,312 and $2,485,092 as to the Polaroid Land equipment, and $17,817, $2,885 and $1,592,530 as to stereo products. (R. 6, 9.)

[5] All Code references are to the Internal Revenue Code of 1939.

[6] Section 40.456–2(b) of Treasury Regulation 130, as amended by T.D. 6026 (1953–2 Cum. Bull. 285).

The Court of Appeals affirmed this holding. (R. 60–69.)[1]

ARGUMENT

This case and the companion case, *Jarecki* v. *G. D. Searle & Co.*, No. 151, involve the identical issue: Whether the taxpayer's income from sales of certain patented products resulted from "discovery" within the meaning of Section 456(a)(2)(B) of the Code, so as to qualify for Korean War excess profits tax relief as "abnormal income". In both cases, the asserted novelty of the taxpayers' products has been assumed (R. 13, 60; *G. D. Searle & Co.* v. *Jarecki*, 274 F. 2d 129, 130 (C.A. 7th)). The arguments which support the Commissioner's view—*i.e.*, that the provisions of Section 456(a)(2)(B) for excess profits tax relief as to income from "exploration, discovery or prospecting" apply only to the natural resources industries—are elaborated in our brief in *Searle* (copies of which are being served upon this petitioner) and will not be repeated here. The brief comments which follow are designed merely to pinpoint various arguments made by this taxpayer and to provide ready reference to the answering arguments developed in the Government's brief in No. 151.

1. The taxpayer asserts (Br. 23–24) that Sections 327(d) and 328 of the Revenue Act of 1918, c. 18, 40 Stat. 1057, are the "progenitors" of Code Section 456(a)(2)(B) of the Korean War Excess Profits

[1] The Court of Appeals set aside (R. 69–71) the Tax Court's holding (R. 14–16) on a minor issue relating to the proper treatment of certain interest. The Commissioner has not sought review here as to that issue.

Tax Law. However, Section 327(d) and 328 were general provisions vesting the Commissioner with wide discretion in the administration of excess profits tax relief. See the Government's brief in *Searle* pp. 22–23 and fn. 27, p. 28. Although that statutory approach—according relief in the case of abnormalities through the exercise of broad administrative discretion—was revived, with some modifications, during the World War II period (see Sections 721(a)(2)(C) and 722 of the Code), it was purposefully abandoned in the Korean War law in favor of a system granting excess profits tax relief upon the basis of more specific criteria and in accordance with specified mathematical formulae. See the Government's brief in *Searle,* pp. 46–49, 57–60.

2. The taxpayer argues (Br. 21–24) that the court below erred in stating that the words "exploration, discovery or prospecting", appearing in Section 456(a)(2)(B) of the Korean War excess profits tax law, were derived from Section 337 of the 1918 Act (the excess profits provision limiting the rate of tax on the sale of discovered mineral property) and other provisions which have dealt, from time to time, with the natural resources industries. This argument is apparently rested on a claim that no analogous special treatment for the relief of taxpayers in the natural resources industries was accorded by successor income tax provisions. But this is not so. The grant of special income tax treatment for discovered mineral resources (whether related to annual depletion of the wasting asset or to the sale of the mineral property

itself) has had a continuous and virtually uninterrupted history (see *Searle* brief, p. 33) dating from the adoption of the 1918 Act. Thus, Section 114(b)(2) of the 1939 Code carried forward the concept of "discovery value" depletion appearing in Sections 214(a)(10) and 234(a)(9) of the 1918 Act. And Section 105 of the 1939 Code preserved the original concept of Section 211(b) of the 1918 Act, which had placed a ceiling on the rate of tax imposed upon proceeds from the sale of the mining property itself. In the interim, substantial *additional* income tax relief for the gradual sale of wasting mineral assets was provided (as an alternative to "discovery value" depletion) by the introduction and gradual expansion of the "percentage depletion" provisions (Section 204(c)(2) of the Revenue Act of 1926, c. 27, 44 Stat. 9, and Section 114(b)(3) and (4) of the Code). See also *Searle* brief, pp. 23–32, and particularly fn. 27, p. 28.

3. The taxpayer also urges (Br. 20) that the use of the phrase "research, or development of tangible property," in World War II Section 721(a)(2)(C), in association with the words "exploration, discovery, prospecting," is indicative of an intention to give broad play to the word "discovery." But, as is shown in detail in the *Searle* brief (pp. 23–28, 32–35, 50–55), the words "exploration," "discovery" and "prospecting" had acquired, long before they were used in Section 721(a)(2)(C), a limited and specific meaning in the internal revenue laws; they had reference to, and only to, natural resources (see, *e.g.*, Sections 105 and 114(b)(2) of the Code). Moreover, the argument is, in all events, self-defeating. In

Section 456(a)(2)(B) of the Korean War law, the phrase "exploration, discovery, or prospecting" stands alone—there is no mention of "research or development of tangible property"—and the omission of the latter phrase, as the congressional reports make unmistakably plain, was deliberately done for an explicit reason: Congress had concluded that to allow special treatment to income from the sale of products resulting from research and development was not feasible because it could not be restricted to "truly meritorious cases" and would make for a "loophole of major dimensions." See *Searle* brief, pp. 6–7, 12–13, 15–18, 65–67, 69–75.

4. The taxpayer's effort (Br. 27–33) to find support in the pertinent provisions[8] of the Treasury Regulations is obviously unavailing. On the face of it, those provisions are fully consistent with the terms of the statute (Section 456(a)(2)) and with the plainly expressed Congressional purpose.[9] See *Searle* brief, pp. 67–69.

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[8] Treasury Regulations 130, Section 40.456–2(b), as amended by T.D. 6026 (1953–2 Cum. Bull. 235):

"(b) * * * Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise property includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)."

[9] H. Rep. No. 3142, 81st Cong., 2d Sess., p. 13 (1951–1 Cum. Bull. 187, 195); and S. Rep. No. 2679, 81st Cong., 2d Sess., p. 14 (1951–1 Cum. Bull. 240, 249).

## CONCLUSION

The decision of the Court of Appeals is correct and its judgment should be affirmed.

Respectfully submitted.

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JANUARY 1961.

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No. 169

IN THE

# Supreme Court of the United States

**OCTOBER TERM, 1960**

POLAROID CORPORATION,
*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

## REPLY BRIEF FOR THE PETITIONER

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## REPLY BRIEF FOR THE PETITIONER

## ARGUMENT[1]

### I

### The legislative history does not support Respondent's contention that the word "discovery" in Section 456(a)(2)(B) applies only to the extractive industries.

Respondent's argument that the words "exploration", "discovery" and "prospecting", as used in Section 456(a)(2)(B), apply only to the extractive industries, is

1. The Brief for the Respondent refers for its principal arguments to the companion Brief for Petitioners in *Jarecki* v. *G. D. Searle & Co.*, No. 151. The latter brief will be referred to herein as the "Government's Brief in *Searle*". The so-called Korean War Excess Profits Tax Law and the Second World War excess profits tax law will be referred to herein as the "Korean War Act" and the "Second World War Act", respectively. All references to statutory provisions are to the Internal Revenue Code of 1939, unless otherwise expressly specified.

predicated upon the assumption that long before these words were used in Section 721(a)(2)(C) of the Second World War Act, the predecessor of Section 456(a)(2)(B), they had acquired a limited and specific meaning in the internal revenue laws as referring only to "natural resources" (Brief for the Respondent, p. 7).[2] The sole basis urged by Respondent for such assumption is a reference to two provisions, expressly dealing with mines, oil and gas wells, of the Revenue Act of 1918 (and later reenactments), in one of which (Section 337) the words "prospecting or exploration and discovery work" were used, and in the other (Section 234(a)(9)) the word "discovery" (Government's Brief in *Searle*, pp. 24-37).

It does not, however, follow from the use of these words in a clearly expressed context as applying only to "mines, oil or gas wells", that Congress intended these words to have the same restricted meaning when in Section 721(a)(2)(C) and Section 456(a)(2)(B) it used them generally without indicating by other phrasing any intention to limit their meaning to their extractive sense.

As we have stated in our Brief for the Petitioner (pp. 23-24), the original source of Section 456(a)(2)(B) was not Section 337 of the Revenue Act of 1918, as Respondent contends (Government's Brief in *Searle*, p. 28). The original source was Section 327 (d) of that Act, the

---

2. It is not clear whether it is Respondent's contention that the words "exploration", "discovery", and "prospecting" apply only to mines, oil and gas wells or to all natural resources. Both positions appear to have been taken by Respondent (Compare, for example, the statement on page 35 of Government's Brief in *Searle* that these words have application "only to the mining, oil and gas industries" with frequent statements that such words apply to the natural resources industries generally (ibid. pp. 6, 7, 22, 32, 55)). In customary usage the limited, restricted meaning which Respondent attributes to these words does not have applicability to such a natural resource as timber. Thus, under Respondent's interpretation, even the timber industry would be ineligible for relief under Section 456(a)(2)(B).

section expressly designed to afford relief from hardship resulting from abnormal conditions affecting the income of a taxpayer in the taxable year, as well as hardship caused by abnormal conditions affecting its tax base.[3] The history of the evolution of Section 327 through the House, Senate and Conference Committee demonstrates that when used in provisions affording relief for abnormalities, the words "prospecting", "exploration" and "discovery" were not restricted in their meaning as referring only to the operations of the extractive industries.

The Revenue Act of 1918 originated in the House as H.R. 12863 (H.R. Rep. No. 767, 65th Cong., 2d Sess., September 3, 1918, 1939-1 Cum. Bull. (Part 2) 86). By Amendment No. 263 the Senate greatly expanded Section 327 of the House bill by including therein various classes of abnormal conditions which had not been mentioned in the original bill (H.R. Rep. No. 1037, 65th Cong., 3d Sess., February 6, 1919, 1939-1 Cum. Bull. (Part 2) 130, 149). When such section passed the Senate, it read, in part, as follows:

> "That in the following cases the tax shall be determined as provided in section 328:
>
> • • • • •
>
> (e) Where the invested capital is materially disproportionate to the net income as compared with

3. Respondent's contention (Government's Brief in *Searle*, p. 28, fn. 27) that Section 327(d) of the Revenue Act of 1918 was the precurser of Section 722 of the Second World War Act is only partially correct. In so far as it dealt with abnormal conditions affecting the tax base, it was the source of Section 722, and of Sections 442-447 of the Korean War Act, which likewise dealt with abnormalities in the base period. In so far as Section 327(d) dealt with abnormal conditions affecting income in the taxable year, it was the forerunner of Section 721 of the Second World War Act and Section 456 of the Korean War Act, which treated with abnormal income in the taxable year.

representative corporations engaged in a like or similar trade or business because:

* * * * *

3. The net income for the taxable year is abnormally high due to the realization in one year of (a) gains, profits or income earned or accrued during a period of years, or (b) *extraordinary gains or profits derived from the sale of property the principal value of which has been demonstrated by prospecting or exploration and discovery work done by the taxpayer* * * *" (Italics supplied). (1922-I-1 Cum. Bull. at 385, 386).

In the Conference Committee the language of the Section was materially altered, and it was finally passed in the form in which it appears in Section 327 of the Revenue Act of 1918 (Appendix to Brief for the Petitioner, pp. 24a-25a). But the language changes were intended only to amalgamate into a single, general classification the various classes of cases entitled to relief as set forth in the Senate version, and not to eliminate any of such classes (H.R. Rep. No. 1037, 65th Cong., 3d Sess., February 6, 1919, 1939-1 Cum. Bull. (Part 2) 130, 149). Thus, Senator Penrose stated:

"* * * Similar action was taken with respect to the so-called relief provisions, which permit the profits tax in any case of exceptional hardship to be fixed by reference to the experience of representative concerns. This amendment, to my mind, is a most admirable one. The Senate greatly increased the classes of cases entitled to this relief. The conferees amalgamated all these classes into a single general class * * *." (65th Cong. 3d Sess., February 12, 1919, 57 Cong. Rec. 3182; quoted in 1922-I-1 Cum. Bull. 383, 387).

Carl A. Mapes, Solicitor of Internal Revenue, in his opinion on the treatment of special cases under Section

327 (1922-I-1 Cum. Bull., 383, 388, 389) expressed the Congressional intent underlying this section as follows:

> "The above quoted statements indicate that Congress intended to retain the relief provisions of the Senate in the bill as finally passed, but that it intended to consolidate all the provisions into one general class. The Senate greatly increased the classes of cases entitled to this relief, and the conferees amalgamated all these classes into a single general class. A better idea may be gained of the relief intended, therefore, when a comparison is made of the bill as it passed the House, as it passed the Senate, and as it finally passed after conference. If all the classes of cases which were embodied in the bill as it passed the Senate were 'amalgamated' or 'consolidated' into one general class, we receive some idea of what was intended by use of the phrase 'abnormal conditions affecting the capital or income of the corporation' by referring to the bill as it passed the Senate • • •.
>
> The thought in the minds of those in charge of the bill was centered upon preventing inequalities and unjust discriminations. If the corporation's tax is high merely because it made large profits upon a normal invested capital, no relief is to be granted. If, however, owing to some abnormal condition affecting its business it is compelled to pay a higher rate of tax than other corporations in its class, then it may show that it is under the 'hardship of inequality' and gain relief under sections 327 and 328 • • •."

In implementation of this Congressional intent, the Solicitor of Internal Revenue ruled that a company which had spent large sums in "experimental and discovery work" for the development of a secret formula, which had not been capitalized, was entitled to relief under Section 327 (1922-I-1 Cum. Bull. 383, 384).

Among the various amendments proposed by the Senate to the House bill, in addition to the aforementioned

Amendment No. 263, amending Section 327, was Amendment No. 288 which introduced into the bill Section 337 (1939-1 Cum. Bull. (Part 2) at 159). As Respondent states, Section 337 was intended by the Senate to provide special relief to the mining, oil and gas industries only; and such intention was made clear, as we have stated, by the express reference to "mines, oil or gas wells" in that section. Had the Senate also intended a restricted application to the words "prospecting or exploration and discovery work" in Section 327, it would in the same way have made such intention clear by a similar reference. But in its amendment of the House's Section 327, the Senate made no such reference; on the contrary, it used the general word "property" in designating, as an abnormal condition, "extraordinary gains or profits derived from the sale of property the principal value of which has been demonstrated by prospecting or exploration and discovery work".

That the words "prospecting or exploration and discovery work", as used by the Senate in Section 327, were understood to apply to all types of industries is apparent from the action of the Conference Committee in amalgamating into one general class all of the classes of abnormal conditions set forth in the Senate version of Section 327. If these words, as there used, applied only to the mining, oil and gas industries, the class of abnormal condition to which they referred could not have been merged into the single general class of abnormal conditions applicable to taxpayers in all industries. Moreover, if the mining, oil and gas industries were intended as the only industries entitled to the benefits of the relief provisions relating to "prospecting or exploration and discovery work", in both Section 327 and Section 337, it is unlikely that such relief would have been split into two separate and unrelated sections.

We respectfully submit that the words "exploration", "discovery" and "prospecting" were similarly intended to have general meaning applicable to qualifying corporations in all industries, when they were repeated in Section 721(a)(2)(C) of the Second World War Act and Section 456(a)(2)(B) of the Korean War Act.

That such intent underlay Section 721 is apparent from the following colloquy on the Senate floor:

> "Mr. Adams: Where is the added benefit in this bill, then, to the mining industry?
>
> • • •
>
> Mr. George: Under this bill, which is entirely remedial, it is permissible to go back 10 years, or even further than that. It is permissible to go back through the whole period of development; and in that way the bill is helpful to the mining industry. *It is not helpful to the mining industry alone. It is helpful to any type of corporation;* but it does result in very great benefit to the particular lines of industry that have a development reaching back over a period of time.
>
> Another thing the amendment does is that various hardship cases are relieved. *Many of them would be mining companies as well as other companies;* but particularly the period through which the cost of development may be spread goes back further than the amendment which was carried to conference. It may go back through the whole period of development. • • •
>
> • • •
>
> Mr. Adams: I was thinking not alone of mining companies. The bill applies equally to an inventor.
>
> Mr. George: It applies to all.
>
> Mr. Adams: It applies to a man who was working on an invention over a period of years, spending his resources, and finally accomplishing his purpose.
>
> Mr. George: The Senator is correct. *It applies to all equally. It applies to every corporation,*

*regardless of the kind of business it is doing.*" (Italics supplied.) (77th Cong., 1st Sess., March 3, 1941, 87 Cong. Rec. 1636, 1637.)

A similar intention, we submit, of providing relief for abnormal income of the class described in Section 456(a)(2)(B) for "any type of corporation", motivated Congress in the enactment of that subsection. The word "discovery", as there used, had the same meaning as in Section 721(a)(2)(C), and in the Senate version of the section which became Section 327(d) of the Revenue Act of 1918.[4] The omission from Section 456(a)(2)(B) of the words "research, or development of tangible property", which had been in Section 721(a)(2)(C), did not change the meaning of "discovery".

It is a well recognized principle of statutory construction that striking one part of a statute does not thereby alter the meaning of the remainder. *United States* v. *Radio Corporation of America*, 358 U. S. 334, 343, 344 (1958); *United States* v. *Dickerson*, 310 U. S. 554, 561 (1940).

Moreover, the Committee reports explaining the motivation for the deletion of these words do not suggest any intention to alter the purport of the words which were retained. Had Congress intended so drastic a measure as to deny relief, under any and all circumstances, to all industries other than the extractive industries, for abnormal income resulting from their pioneer discoveries —a form of relief available to all industries under both previous excess profits tax laws—it would be expected that the Congressional reports would have clearly so stated. We submit, as we shall demonstrate in Point II hereof, that Congress did not intend so sweeping a change.

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4. Respondent concedes that "discovery" in Section 456(a)(2)-(B) has the same meaning as in Section 721(a)(2)(C) (Government's Brief in *Scarle*, pp. 15-16).

## II

**Respondent has misconstrued the Congressional Committee Reports as to the effect intended by the omission from Section 456(a)(2)(B) of the words "research, or development of tangible property" used in Section 721(a)(2)(C) of the Second World War Act.**

Respondent's argument that the deletion of "research, or development of tangible property" had the effect of barring relief for abnormal income resulting from the sale of tangible property arising out of any and all scientific discoveries (Government's Brief in *Searle*, pp. 16-17) is based upon an improper interpretation of the Committee Reports.[5]

The Committee Reports stated that the reason for such deletion was to plug "a potential loophole" found to exist in the old law. We respectfully suggest that such potential loophole stemmed from the uncertainty, in various cases brought under the research and development provisions of Section 721(a)(2)(C), as to what portion, if any, of the taxpayer's income in the taxable year was the direct result of the special demand for the particular product arising from the taxpayer's alleged research and development. *Keystone Macaroni Manufacturing Co.* v. *Commissioner of Internal Revenue*, 18 T.C. 1078 (1952); *Atlumor Manufacturing Co., Inc.* v. *Commissioner of Internal Revenue*, 12 T.C. 949 (1949); *Eitel-McCullough, Inc.* v. *Commissioner of Internal Revenue*, 9 T.C. 1132 (1947).

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5. H.R. Rep. No. 3142, 81st Cong., 2d Sess., December 2, 1950, 1951-1 Cum. Bull. 187, 195; Senate Rep. No. 2679, 81st Cong., 2d Sess., December 18, 1950, 1951-1 Cum. Bull. 240, 249.

As we have demonstrated in our Brief for the Petitioner (p. 25), in the case of the discovery of a new basic invention, no potential loophole could exist since, but for the discovery, there would have been no income at all from such source. We submit that since granting a right to relief for such a discovery could not result in any potential loophole, Congress had no intention of barring it from relief under Section 456.

It was, we urge, only the difficulty of directly relating the income to the research and development in cases not involving invention in the order of discovery, with which Congress was concerned, and not, as Respondent contends (Government's Brief in *Searle*, pp. 47-48), the problem of adjusting the quantum of relief for improved business conditions or other external factors, which may have contributed to the taxpayer's income in the taxable year.[6] These external factors affected the income of mining companies as well as companies in other fields, and appropriate adjustments therefor were made in computing net abnormal income in cases qualifying for relief under Section 721(a)(2)(C). See *Simpson Richey* v. *Commis-*

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6. *Ibid.* The Committees' express reference only to avoiding "the *introduction* of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (Section 722)" [italics supplied], suggests that Congress was not particularly disturbed by any administrative discretions which had been required under Section 721. This is confirmed by the repetition in Section 456 in virtually identical language of the provisions of Section 721 for computation of net abnormal income and its attribution to other years (Brief for the Petitioner, p. 26).

We respectfully urge that the administrative discretion regarded by the Committees as undesirable and unfeasible was an administrative discretion directed to a construction of the income resulting from the alleged research and development, when the actual income from such source was unascertainable. Such an administrative discretion would have been of the type which had been required under Section 722 in determining the constructive average base period net income (Government's Brief in *Searle*, p. 40).

*sioner of Internal Revenue*, 19 T.C. 926, 933 (1953) (mining company); *W. B. Knight Machinery Company* v. *Commissioner of Internal Revenue*, 6 T.C. 519 (1946); *Rochester Button Company* v. *Commissioner of Internal Revenue*, 7 T.C. 529 (1946); *Ramsey Accessories Manufacturing Corporation* v. *Commissioner of Internal Revenue*, 10 T.C. 482 (1948); *Keystone Brass Works* v. *Commissioner of Internal Revenue*, 12 T.C. 618 (1949) (industrial companies).

Such adjustments are still to be made under Section 456, as is apparent from the retention of the following provision in Section 40.456-3(b) of the Regulations:

> "• • • To the extent that any items of net abnormal income in the taxable year are the result of such factors as high prices, low operating costs, increased demand, or decreased competition, such items shall not be attributed to other taxable years • • •." (Treasury Regulations 130 (1951), Section 40.456-3(b)).

In the present case, if Petitioner is successful herein, the amount of net abnormal income resulting from Petitioner's discoveries and the respective amounts thereof to be attributed to the prior years, have been agreed upon by stipulation (R. 57-58, fols. 62-63).

We respectfully submit that a proper interpretation of the Committee Reports supports the conclusion expressed in our Brief for the Petitioner that the deletion of "research, or development of tangible property" did not affect Petitioner's right to relief under Section 456 for its discovery income.

## CONCLUSION

**It is respectfully submitted that the judgment of the Court below should be reversed and the case remanded to the Tax Court for the fixing of Petitioner's net abnormal income and the attribution thereof to prior years, in accordance with the stipulation herein.**

Dated: February 7, 1961.

Respectfully submitted,

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## SUPPLEMENTAL REPLY BRIEF FOR PETITIONER

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Summary of H.R. 9827, as Agreed by Conferees, Prepared by Joint Committee, December 1950 ..... 3, fn.

Webster's New International Dictionary, 2d ed. ..... 4, fn.

IN THE

# Supreme Court of the United States

**OCTOBER TERM, 1960**

No. 169

POLAROID CORPORATION,

*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

## SUPPLEMENTAL REPLY BRIEF FOR PETITIONER

In Point II of our main brief we asserted the alternative position that if Polaroid's income from its basic scientific discoveries was not entitled to be classified as "discovery" income under subparagraph (B) of Section 456(a)(2), such income was entitled to classification under the last sentence of Section 456(a)(2), which provided for additional classifications of income of "any class" under regulations prescribed by the Secretary. With respect to such contention, the Government in its Reply Brief has advanced for the first time the argument that this last

sentence was included in the section through inadvertence. No such contention was made by the Government in its principal brief in this case or the *Searle* case, nor was any such contention made by the Government in either case in the Courts below. The purpose of this Supplemental Reply Brief for Petitioner is to answer this last-minute contention of the Government.

## I

### Contrary to the Government's contention, the legislative history shows that the last sentence of Section 456(a)(2) was deliberately included.

The Government's argument that the last sentence of Section 456(a)(2) was included in the section by inadvertence is refuted by the legislative history. It is based entirely on a misinterpretation of the effect of a clerical amendment by the Senate to Section 456(a)(1).

In the original House bill, Section 456(a)(1) [Section 454(A)(1) of the House bill] the term "abnormal income" was defined as embracing "income of any class includible in the gross income of the taxpayer", if the amount of such income of such class exceeded the average of the gross income of the same class for the four prior taxable years. Section 456(a)(2) [Section 454(A)(2)] of the original House bill set forth the four expressly defined classes of income which appear in the section as finally enacted, as well as the last sentence: "The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary".

The Senate Finance Committee proposed two amendments: Amendment 200 sought to add after the words

"income of any class" in paragraph (a)(1) the words "described in paragraph (2)". Amendment 201 sought to strike out the last sentence of paragraph (a)(2), thus limiting the relief to only the four classes of income expressly defined in that paragraph.

In Conference, the Senate receded from its Amendment 201; and the last sentence of paragraph (a)(2), providing for additional classifications pursuant to regulations to be prescribed by the Secretary, was left intact. (H.R. Rep. No. 3233, Conference Report, 81st Cong. 2d Sess. 1951-1 Cum. Bull. 268, 277.)

That this action on the part of the Senate was not inadvertent, as the Government asserts, but was deliberately done for the purpose of extending the scope of the section to other classes of income in addition to those expressly described, as it had been extended under Section 721(a)(2) of the Second World War Act, is confirmed not only by the reference in the report of the Staff of the Joint Committee* to "income of other classes permitted under regulations prescribed by the Secretary", to which the Government adverts in Point III of its Reply Brief (Gov't's Reply Br. p. 10), but also by the following comment of Senator George in reporting on the House—Senate Conference on the Senate floor:

> "In connection with abnormalities in income in the tax period, the Senate conferees receded on a House bill provision which would give the Secretary of the Treasury the authority to prescribe classifications in addition to those specified in the bill." (96 Cong. Rec. p. 16,978, December 22, 1959.)

* Summary of H.R. 9827 "The Excess Profits Tax Act of 1950 as Agreed to by the Conferees, prepared by the Joint Committee on Internal Revenue Taxation, December 1950, p. 9.

With respect to the Senate's other amendment, No. 200, the Conference report stated: "Amendments Nos. 194, * * * 200: These are clerical amendments. The House recedes". (H.R. Rep. No. 3231, Conference Report, 81st Cong. 2d Sess. 1951-1 Cum. Bull. 268, 277.)

It thus is apparent that no substantive change was intended by Amendment 200 which added to the definition of abnormal income in paragraph (a)(1) after the words "income of any class" the phrase "described in paragraph (2)". This was a clerical language change which did not change the meaning of the definition of abnormal income as worded in the original House bill. The only proposed amendment that was substantive in nature was No. 201, to delete the last sentence of paragraph (a)(2), and on this the Senate receded and agreed to the inclusion of such last sentence.

Nor is there any contradiction, as the Government asserts, between paragraph (a)(1) with the words "as described in paragraph (2)" and paragraph (a)(2) with the last sentence included. The phrase "described in paragraph (2)" is tantamount to "hereinafter classified" and refers not only to the four classes expressly described in subparagraphs (A)-(D) of paragraph (2) but also to the additional classes to be established pursuant to the last sentence of paragraph (2).* All that the addition of the phrase accomplished was to make crystal clear in the definition of abnormal income that it was not income of "any

* Webster's New International Dictionary (2d Edition) gives as one of the definitions of the word "describe", "5. to distribute into parts, groups or classes; to mark off; to class; to apportion." Substituting that definition for the phrase "described in paragraph (2)", paragraph (a)(1) of Section 456 would read: "The term 'abnormal income' means income of any class distributed into parts, groups or classes in paragraph (2) * * *."

class", as such class of income might be unilaterally conceived by the taxpayer, but income of "any class", as either expressly described in paragraph (2) or thereafter described by the Secretary for the additional classes to be established pursuant to the last sentence, that was to be subjected to the mathematical formula for determination of abnormality. While this clarification was not essential since the provision without the added phrase had been similarly interpreted, it was helpful as eliminating any possible doubt as to interpretation.

In converting a clerical amendment into a substantive amendment to support an argument, contrary to the demonstrated legislative history, that the inclusion of the last sentence was inadvertent, the Government would have one believe that (i) the House did not know what it was doing when it drafted the original bill with the last sentence of paragraph (a)(2) included, (ii) the Senate conferees did not know what they were doing when they receded from their amendment to delete this last sentence, (iii) the Senate and House conferees did not know what they were doing when they characterized as a clerical amendment the Senate amendment which added the phrase "as described in paragraph (2)" to paragraph (1), and (iv) the Joint Committee staff and Senator George were in error in stating that additional classifications of income under regulations to be prescribed by the Secretary had been provided for in the statute, as finally enacted. The Government's argument ascribes no meaning whatever to the Senate's action, after the conference, of receding from the only proposed substantive amendment it made, to eliminate the last sentence of paragraph (2). In effect, the Government, in its argument, has made the technical

amendment one of substance, and the substantive amendment a technical one.

The failure of the House Committee report,* in reporting the bill, to make any reference to the omnibus provision in the last sentence of paragraph (a)(2) is explained by the fact that the bill was making no change in such respect from the comparable provision in Section 721(a)(2) of the Second World War Act and accordingly no reason existed for any comment concerning it in the Committee Report. The Committee Report confined itself to a statement of the changes which had been made in the bill from the provisions of the prior law, and of the purpose of such changes.

We respectfully submit that the legislative history conclusively demonstrates that the House from the outset intended to include in paragraph (a)(2) the omnibus provision for additional classifications by the Secretary, as had been provided in Section 721(a)(2) of the old law, that the Senate at first sought to eliminate such provision and confine abnormal income to the four classes expressly defined in the statute, but that the Senate thereafter deliberately yielded to the point of view of the House and agreed to abandon its amendment and to restore the omnibus provision which, in virtually identical language to that used in Section 721(a)(2), provided for additional classifications of income of "any class" under regulations to be prescribed by the Secretary.

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* H.R. Rep. No. 3142, 81st Cong. 2d Sess., 1951-1 Cum. Bull. 550.

## II

**The last sentence of Section 456(a)(2) requires the classification of all classes of income not expressly classified in such section.**

Both Section 456(a)(2) and Section 721(a)(2) of the prior law, in virtually identical language, provided in their respective last sentences for "the classification of income of any class" not described in the subparagraphs of the section. In Section 456(a)(2) such classification is "subject to regulations prescribed by the Secretary"; in Section 721(a)(2) the classification was "subject to regulations prescribed by the Commissioner with the approval of the Secretary".

The Government concedes that under Section 721(a)(2) it was mandatory for the Commissioner to classify all classes of income not expressly described in the section, and that the test of whether such income was abnormal income was provided by the mathematical formula set forth in Section 721(a)(1).

The Government's argument in Point III of its Reply Brief that the same result does not obtain under the identical language of Section 456(a)(2) is based solely on its misconception of the effect of the clerical amendment which added in Section 456(a)(1) the phrase "described in paragraph (2)" after the words "income of any class". As we have shown in Point I hereof, the inclusion of this phrase effected no substantive change and the definition of abnormal income in Section 456(a)(1) (except for the change in the percentage in the formula for determining

abnormality) should be construed as the same as that in Section 721(a)(1).

Section 456(a)(2), we submit, is a classification section, to be used only as a tool for the determination of abnormality under Section 456(a)(1), as Section 721(a)(2) was used to determine abnormality under Section 721(a)(1). The addition of the phrase "described in paragraph (2)" in Section 456(a)(1) does not limit the operability of that subsection, as the Government contends. The formula there provided for the determination of abnormal income is operable with respect to any class of income, whether it is a class of income expressly described in the statute or an additional class of income established pursuant to the last sentence of paragraph (2).

Notwithstanding that this last sentence provides for classification of "income of any class", the identical words used in Section 721(a)(2), the Government has advanced the strange argument that these identical words should be given different interpretations. While the Government concedes that these words, as used in Section 721(a)(2), required the classification of all classes of income, the same words, as used in Section 456(a)(2), are stated to give the Secretary the discretion to elect to classify some classes of income but to refuse to classify others.

We respectfully submit that there is no justification for this claimed difference in the purport of identical words in identical provisions. The reference in the Committee reports to the deletion of "research, or development of tangible property", which had appeared in Section 721(a)(2)(C) as a part of one enumerated class of income, constitutes no basis for twisting the language of the statute requiring classification of all classes of income into a provision giving the Secretary a discretion to determine

eligibility for relief. Moreover, such interpretation would make the provision unconstitutional, as has been pointed out in our main brief.

March 17, 1961.

Respectfully submitted,

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# SUPREME COURT OF THE UNITED STATES

Nos. 151 AND 169.—OCTOBER TERM, 1960.

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|---|---|
| John T. Jarecki, Former Collector of Internal Revenue, et al., Petitioners, v. G. D. Searle & Co. | On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit. |
| 151 | |
| Polaroid Corporation, Petitioner, v. Commissioner of Internal Revenue. | On Writ of Certiorari to the United States Court of Appeals for the First Circuit. |
| 169 | |

[June 12, 1961.]

MR. CHIEF JUSTICE WARREN delivered the opinion of the Court.

These cases present problems in the interpretation of § 456 (a) of the Internal Revenue Code of 1939, a section of the Excess Profits Tax Act of 1950, 64 Stat. 1137. The Act, which is intended to tax at high rates unusually high profits earned during the Korean War, imposes a tax on profits in excess of an amount deemed to represent the taxpayer's normal profits.[1] Recognizing, however, that some profits otherwise subject to tax under this scheme might stem from causes other than the inflated wartime economy, Congress enacted § 456. This section grants relief in certain cases of "abnormal income" as defined in § 456 (a) [2] by allocating some of this income

[1] See H. R. Rep. No. 3142, 81st Cong., 2d Sess. 2, S. Rep. No. 2679, 81st Cong., 2d Sess. 2.

[2] Section 456 (a) provides in part:

"(a) *Definitions.* For the purpose of this section—

"(1) *Abnormal income.* The term "abnormal income" means income of any class described in paragraph (2) includible in the gross

to years other than those in which it was received for purposes of computing the tax.

The dispute in these cases is whether income from the sales of certain new products falls within the statutory definition of "abnormal income." Taxpayers claim that the income from the sales of their products is income resulting from "discovery." They claim it is therefore "abnormal income" within the class defined by § 456 (a)(2)(B) as

> "Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months."

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income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years the taxable years during which the taxpayer was in existence.

"(2) *Separate classes of income.* Each of the following subparagraphs shall be held to describe a separate class of income:

"(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

"(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

"(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

"(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

"All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

Taxpayer in No. 151 is a corporation engaged in the manufacture and marketing of drugs. As a result of research extending for more than 12 months, it produced two new drugs, "Banthine," used in the treatment of peptic ulcers, and "Dramamine," for relief from motion sickness. Taxpayer received patents on both drugs, and it asserts that both were new products and not merely improvements on pre-existing compounds. Taxpayer received income from the sale of "Banthine" and Dramamine" in the years 1950 through 1952. It paid its tax without claiming relief under § 456, and then claimed a refund. On denial of its claim, taxpayer filed a complaint in the District Court for the Northern District of Illinois. The District Court dismissed the complaint, but the Court of Appeals for the Seventh Circuit reversed. It held that "discovery" might include the preparation of new products and that the case must be remanded for a trial on the issue of whether taxpayer's drugs "were actually discoveries." 274 F. 2d 129, 131.

Taxpayer in No. 169 is the inventor and producer of the "Polaroid Land Process," a camera and film which produce a photograph in 60 seconds, and the "Polaroid 3–D Synthetic Polarizer," a device incorporated in the "viewers" through which audiences watched the three dimensional motion pictures in vogue some years ago. These inventions, each the product of more than 12 months research, are novel, according to taxpayer, and each has been patented. The Polaroid Land equipment was the subject of 238 patents by the end of 1958, and taxpayer characterizes this invention as "revolutionary." Its production was a new departure in the business of taxpayer, which had hitherto been engaged primarily in manufacturing and selling such optical products as polarizing sunglasses, visors and camera filters. In its returns for 1951 through 1953 taxpayer utilized the provisions of

§ 456 in computing its tax on income from the sales of its photographic equipment and 3–D polarizers. The Commissioner determined that § 456 was not applicable, and the Tax Court upheld his determination of a deficiency. The Court of Appeals for the First Circuit affirmed, holding that taxpayer's inventions were not "discoveries" and its income from their sale not "abnormal income." 278 F. 2d 148.

We granted certiorari in each case to resolve the conflict between the decisions of the First and Seventh Circuits. 364 U. S. 812, 813.

I.

For present purposes we accept, as did the First Circuit, taxpayers' assertions of the novelty of their products. But we also agree with that court that taxpayers' inventions are not "discoveries" as that word is used in § 456 (a)(2)(B) and that income from sales of the new products may not receive the special treatment provided by § 456.

We look first to the face of the statute. "Discovery" is a word usable in many contexts and with various shades of meaning. Here, however, it does not stand alone, but gathers meaning from the words around it. These words strongly suggest that a precise and narrow application was intended in § 456. The three words in conjunction, "exploration," "discovery" and "prospecting," all describe income-producing activity in the oil and gas and mining industries, but it is difficult to conceive of any other industry to which they all apply. Certainly the development and manufacture of drugs and cameras are not such industries. The maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended

breadth to the Acts of Congress. See, *e. g.*, *Neal* v. *Clark*, 95 U. S. 704, 708–709. The application of the maxim here leads to the conclusion that "discovery" in § 456 means only the discovery of mineral resources.

When we examine further the construction of § 456 (a)(2) and compare subparagraphs (B) and (C), it becomes unmistakably clear that "discovery" was not meant to include the development of patentable products. If "discovery" were so wide in scope, there would be no need for the provision in subparagraph (C) for "income from the sale of patents, formulae, or processes." All of this income, under taxpayers' reading of "discovery," would also be income "resulting from . . . discovery" within subparagraph (B). To borrow the homely metaphor of Judge Aldrich in the First Circuit, "if there is a big hole in the fence for the big cat, need there be a small hole for the small one?" The statute admits a reasonable construction which gives effect to all of its provisions. In these circumstances we will not adopt a strained reading which renders one part a mere redundancy. See, *e. g.*, *United States* v. *Menasche*, 348 U. S. 528, 538–539.

Taxpayers assert that it is the "ordinary meaning" of "discovery" which must govern. We find ample evidence both on the face of the statute and, as we shall show, in its legislative history that a technical usage was intended. But even if we were without such evidence we should find it difficult to believe that Congress intended to apply the layman's meaning of "discovery" to describe the products of research. To do so would lead to the necessity of drawing a line between things found and things made, for in ordinary present-day usage things revealed are discoveries, but new fabrications are inventions.[3] It

[3] In lay terms, Polaroid's photographic equipment and Searle's drugs are probably better called inventions than discoveries. Webster's New International Dictionary, Unabridged (2d ed.) p. 745,

would appear senseless for Congress to adopt this usage, to provide relief for income from discoveries and yet make no provision for income from inventions. Perhaps in the patent law "discovery" has the uncommonly wide meaning taxpayers suggest, but the fields of patents and taxation are each lores unto themselves, and the usage in the patent law (which is by no means entirely in taxpayers' favor) [4] is unpersuasive here. All the evidence is to the effect that Congress did not intend to introduce the difficult distinction between inventions and discoveries into the excess profits tax law.

The relevant legislative history fortifies the conclusions to which the words of the statute lead us. The word "discovery" has been used for many years in the tax laws, and has always been used with the limited meaning of the finding of mineral deposits. In the Revenue Act of 1918, enacting one of the earliest excess profits tax laws, a limit was placed on the excess profits tax on income from "a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer." Revenue Act of

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makes this distinction: "One discovers what existed before, but had remained unknown; one invents by forming combinations which are either entirely new, or which attain their end by means unknown before: as, Columbus *discovered* America; Newton *discovered* the law of gravitation; *Edison* invented the phonograph. . . ."

[4] The United States Constitution, Art. I, § 8, cl. 8 gives Congress the power to secure to "Inventors the exclusive Right to their . . . Discoveries." While the terms "discover" and "discovery" are used throughout the patent statutes, they seem generally to appear with "invent" and "invention" as if the terms have separate meanings. See, *e. g.*, 35 U. S. C. § 101: "Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter . . . may obtain a patent therefore. . . ." And see *Dolbear* v. *American Bell Telephone Co.* (*Telephone Cases*), 126 U. S. 1, 532–533.

1918, § 337, 40 Stat. 1096.[5] An identical limitation was imposed on the income tax levied under that Act,[6] and the same usage of "discovery" obtained in the allowance of depletion deductions.[7] The limitation on the income tax on the proceeds of the sale of mineral deposits was re-enacted without significant change in the Revenue Acts of 1921, 1924, 1926, 1928, 1932, 1936 and 1938.[8] It remains in the income tax provisions of the Internal Revenue Code of 1939 as § 105 and has been carried forward as § 632 of the 1954 Code. In each re-enactment "discovery" is linked with "exploration" and "prospecting," and in each the word is restrictively applied to extractive industries. A correspondingly narrow use of "discovery" has continued since 1918 in the depletion allowance sections[9] and appears in § 114 (b)(2) of the 1939 Code. In the more than 30 years preceding the enactment of the sec-

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[5] This section was re-enacted by the Revenue Act of 1921, § 337, 42 Stat. 277.

[6] Revenue Act of 1918, § 211 (b), 40 Stat. 1064.

[7] Revenue Act of 1918, §§ 214 (a)(10), 234 (a)(9), 40 Stat. 1067, 1078, providing "That in the case of mines, oil and gas wells, discovered by the taxpayer . . . where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of discovery. . . ."

[8] Revenue Act of 1921, § 211 (b), 42 Stat. 237; Revenue Act of 1924, § 211 (b), 43 Stat. 267; Revenue Act of 1926, § 211 (b), 44 Stat. 23; Revenue Act of 1928, § 102 (a), 45 Stat. 812; Revenue Act of 1932, § 102 (a), 47 Stat. 192; Revenue Act of 1936, § 105, 49 Stat. 1678; Revenue Act of 1938, § 105, 52 Stat. 484.

[9] Revenue Act of 1921, §§ 214 (a)(10), 234 (a)(9), 42 Stat. 241, 256; Revenue Act of 1924, § 204 (c), 43 Stat. 260; Revenue Act of 1926, § 204 (c)(1), 44 Stat. 16; Revenue Act of 1928, § 114 (b)(2), 45 Stat. 821; Revenue Act of 1932, § 114 (b)(2), 47 Stat. 202; Revenue Act of 1934, § 114 (b)(2), 48 Stat. 710; Revenue Act of 1936, § 114 (b)(2), 49 Stat. 1686; Revenue Act of 1938, § 114 (b)(2), 52 Stat. 495.

tion here at issue, during which time "discovery" was used and re-used in successive taxing statutes, the word developed into a term of art of precise and limited meaning.

The Excess Profits Tax Act of 1940, 54 Stat. 975, made specific mention of more types of "abnormal income" qualifying for relief than did the earlier excess profits tax statutes, but there is no indication that it worked any transformation in the meaning of "discovery." Section 721, 54 Stat. 986, as amended, 55 Stat. 21, classified six types of "abnormal income." Among them was the following, at § 721 (a)(2)(C):

> "Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months."

This was the first time specific provision was made for income from invention, relief in cases of such income having previously been obtainable, if at all, only under the "general relief" provisions of the earlier Acts.[10] It is instructive that the formula "exploration, discovery, or prospecting" was not considered broad enough to cover invention and that the words "research" and "development" were added to cover that source of income. Plainly, "discovery" retained in the World War II excess profits Act the limited meaning which it had had in the

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[10] Section 327 (d) of the Revenue Act of 1918, 40 Stat. 1093, gave the Commissioner power to grant relief in any case in which "the tax . . . would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship. . . ." Section 721 of the World War II law classified specific types of abnormal income for purposes of computing the tax, and, while it provided relief for all abnormal income of whatever class, was not considered a "general relief" section.

previous Acts and which it continued to have in the income tax provisions of the then-current code.[11]

The relief provisions of the Excess Profits Tax Act of 1950, which we here construe, were modeled in part on § 721 of the World War II Act, but were different in significant respects. In the classifications of income in the new § 456, Congress gave separate treatment to income from discovery of minerals and income from invention. It provided relief in subparagraph (B) for "income *resulting from* exploration, discovery, or prospecting," but provided in subparagraph (C) only for "income *from the sale of* patents, formulae, or processes." (Emphasis added.) Subparagraph (C) does not encompass all income from inventions. It does not cover income from the sale of products made under a new patent, the sort of income at issue here. Taxpayers assert that the income from their inventions is, realistically speaking, as "abnormal" in their businesses as the discovery of a new mine would be in the business of a prospector. Their income is within the spirit of § 456, they say, and should be held to be within the letter of subparagraph (B). It is clear, however, that Congress, while it may have recognized the abnormal nature of this sort of income, chose deliberately to deny relief for it and to limit relief in cases of research and development to that provided in subparagraph (C).

The relief provisions of the World War II Act had been intended to provide "flexible rules," [12] and their application had often been an uncertain affair. In administering § 721 the Commissioner often faced the difficult task

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[11] I. R. C. of 1939, §§ 105, 114 (b)(2). It was expressly provided by § 728 of the World War II excess profits tax statute, 54 Stat. 989, that the words used in that statute should have the same meaning as when used in the income tax chapter of the Code.

[12] H. R. Rep. No. 146, 77th Cong., 1st Sess. 2.

of separating income which was the product of "research or development" from that resulting merely from improved management or sales efforts. The difficulty of distinction led the Tax Court to hold that the distinction must be made "by exercising common sense and judgment," and that "It is entirely possible that the allocation made by one person would never match that made by another." *Ramsey Accessories Mfg. Corp.* v. *Commissioner*, 10 T. C. 482, 489. Congress in 1950 recognized the delay and uncertainty caused by the element of administrative discretion in this and other [13] sections and set about drafting an excess profits tax law on the principle that "subjective judgments . . . should be avoided in the new law." H. R. Rep. No. 3142, 81st Cong., 2d Sess. 20. This principle was expressly followed in the drafting of § 456. The Senate Committee reported on § 456 as follows:

> "The equivalent provision in the World War II law (sec. 721) also permitted adjustments with reference to certain other types of income, particularly that resulting from the sale of tangible property arising out of research and development which extended over a period of more than 12 months. This provision in the old law was a potential loophole of major dimensions. Because there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (sec. 722), and because the need for a

[13] The "general relief" section of the World War II Act, § 722, 54 Stat. 986, as amended, 55 Stat. 23, 701, 56 Stat. 914, 57 Stat. 56, 601, 58 Stat. 55, provided for adjustments in the computation of base period income if the taxpayer established, among other things, "what would be a fair and just amount representing normal earnings" during the base period.

> reallocation of such income seemed to be materially less than for the other classes of income described above, the bill omits this item from the list of abnormal types of income for which a reallocation can be made." S. Rep. No. 2679, 81st Cong., 2d Sess. 14.

The House Committee Report was virtually identical. H. R. Rep. No. 3142, 81st Cong., 2d Sess. 13.

Taxpayers recognize, as they must, that Congress intended its change in language to limit the kinds of income eligible for relief. They say, however, that not all income from research and development was excluded. That which comes from inventions not merely patentable but also sufficiently revolutionary to be called "genuine discoveries" is still within the protection of § 456. We find it impossible to believe that an amendment designed to eliminate uncertainty and administrative discretion would introduce into the law—without a congressional word of warning or explanation—a distinction as vague, as dependent upon nuances of scientific opinion, and as unprecedented as that urged by taxpayers.

II.

Taxpayers have another argument, which the First Circuit rejected and which the Seventh Circuit did not reach. Paragraph (1) of § 456 (a) defines "abnormal income" as "income of any class described in paragraph (2)" which meets certain requirements. Paragraph (2) lists four classes of income and provides in its concluding sentence:

> "The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

Taxpayers argue that even if the income here at issue was not provided for under any of the subparagraphs of paragraph (2), it is nevertheless included within this final sentence and is hence eligible for relief.

We need not decide the precise effect of the sentence relied on. In light of the clear purpose of Congress in enacting § 456 to cut down not only the amount of administrative discretion which had prevailed under the predecessor section but also the scope of available relief, the power of the Secretary to extend relief far beyond the four corners of the statute may be doubted.[14] It is sufficient to note that, unlike its predecessor (which made relief available for all "abnormal income," whether or not specified in a particular class),[15] § 456 applies only to those classes specified in § 456 (a)(2). Section 456 does not apply in terms to all abnormal income and contains no indication that the Secretary should create administrative classifications embracing all such income. And even if the sentence relied on gives the Secretary power to expand the classes of abnormal income somewhat beyond the four enumerated in the statute, he has clearly not done so here. The regulations[16] specifically provide that

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[14] In fact, the Committee reports state that "Adjustments . . . [under § 456] are limited to income arising out of" the four classes specified in subparagraphs (A) through (D). H. R. Rep. No. 3142, 81st Cong., 2d Sess. 13, S. Rep. No. 2679, 81st Cong., 2d Sess. 14.

[15] Excess Profits Tax Act of 1940, § 721, 54 Stat. 986, as amended, 55 Stat. 21. Section 721 (a)(1) defines "abnormal income" as "income of any class includible in the gross income of the taxpayer. . . ."

[16] Treas. Regs. § 40.456-2 (b) (1951), as amended, T. D. 6026, 1953-2 Cum. Bull. 235: "Other income, not within a class described in subparagraphs (A)-(D) of section 456 (a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456 (a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class

"Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section." This specific exclusion is clearly in furtherance of the purpose of Congress in deleting "research" and "development" income from its classification of abnormal income. The Commissioner, effecting the will of Congress, has barred relief for the type of income here at issue.

The last sentence of the regulation, on which taxpayers also rely, does not aid them. It provides merely that "research" and "development" income is eligible for relief if it is properly includible in a class of income to which § 456 otherwise applies. As we have held, however, taxpayers' income does not fall within any such class.

Therefore, the judgment of the Court of Appeals for the Seventh Circuit must be reversed and the judgment of the Court of Appeals for the First Circuit affirmed.

*It is so ordered.*

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of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable for example, the class described in section 456 (a)(2)(D)."